

# The Truth, The Whole Truth, and Nothing but the Truth: Fulfilling the Promise of Truth in Lending

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*Evaluating the cost of credit and comparison shopping in the modern credit environment can be a daunting task, even for the most sophisticated shoppers. Lenders increasingly unbundle the costs of their loans from the interest rate into an array of fees, outsource their overhead to third parties who add to consumers' costs, and unveil amazingly complex loan products that dazzle and confuse borrowers. At the same time, the preemption of state usury and consumer protection laws by Congress and the federal banking agencies has spurred deregulation at the state level. Today, the consumer credit marketplace is governed almost exclusively by disclosure rules. The subprime mortgage crisis of 2007 resulted from allowing the market to police itself and from the failure of disclosure to curb abuses.*

*Nearly forty years ago, Congress addressed the problems caused by lack of transparency in credit pricing when it enacted the Truth in Lending Act (TILA). Congress intended to promote informed consumer shopping and a level playing field for lenders by requiring standard disclosure of the cost of credit, most simply through the annual percentage rate (APR) and the finance charges upon which the APR is based. The value of the APR disclosure has deteriorated since 1968, due to exclusions from the finance charge definition created primarily by the Federal Reserve Board.*

*This Article documents the history of this decline for the first time and describes the consequences of an APR disclosure that has become incrementally weaker as an indicator of the true cost of the credit. This Article also draws upon financial literacy, cognitive psychology, and behavioral economics literature to justify the need for a more effective APR.*

*The authors posit a simple litmus test for the finance charge that creates a more effective APR. They discuss why this test is superior to other proposed*

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*definitions of the finance charge and respond to arguments that a fee-inclusive APR is unhelpful to consumers and harms the industry.*

*This Article is particularly timely because the Federal Reserve Board is currently undertaking a sweeping overhaul of TILA disclosure regulations, including the finance charge definition. Given the state of the credit marketplace, the authors conclude that a robust APR is even more critical now than it was in 1968.*

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## Introduction

The consumer credit marketplace is a complex maze. Consumers are not equipped to avoid the traps and land mines. Over the years, federal disclosure law has replaced state substantive protections, leaving the “informed” consumer in the role of the marketplace police. The results have been abusive lending practices and cyclical economic meltdowns. The Article documents the history and consequences of the decline of the most important single piece of consumer shopping information: the annual percentage rate (APR), a disclosure mandated by the federal Truth In Lending Act (TILA).<sup>1</sup> Relying upon financial literacy, cognitive psychology, and behavioral economics literature, the authors justify the need for a more effective APR and propose a bright-line litmus test for the APR. This Article is particularly timely because the Federal Reserve Board (FRB) is currently undertaking a sweeping overhaul of TILA disclosure regulations.

Evaluating the cost of credit and comparison shopping in the modern credit environment can be a daunting task. Consider these common examples.

Which mortgage loan product do you think carries the lower price tag: a fixed-rate mortgage loan advertising a prime market interest rate supplemented by a 2% loan origination fee and \$3,500 in closing costs, or the same loan offered at 1% over prime rate with no origination fee but \$2,500 in closing costs?

In the case of credit cards, which offer seems better to you? One with a periodic rate of 10.9%, an over-limit fee of \$25, balance transfer fee of 3%, and late fee of \$29 or one with a periodic rate of 11.9%, an over-limit fee of \$25, balance transfer fee of 2%, and late fee of \$25? Did you look at the default rates? Were there initial teaser rates? Are the interest rates fixed or adjustable?

If you need emergency car repairs, which is more expensive: a two-week payday loan that costs \$32 for every \$100 you borrow, or a bank overdraft loan to cover your car repair check that triggers a one-time fee of \$35 plus \$5 per day until you bring your account current? Would you be better off taking a cash advance on your credit card or charging the repairs when the cash advance rate on your credit card is 24.9%, the usual rate is 12.9%, and the default rate is 28.9%?

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1 15 U.S.C. §1601 *et seq.* (2000).

These examples demonstrate the complexities and challenges consumers face when attempting to make wise financial decisions. Lenders offer a variety of loan products, with a range of differing terms accompanied by add-on products, such as insurance or identity theft protection. New credit products emerge almost daily, many containing complicated features, such as adjustable interest rates with initial teaser rates, interest-only payments, and payment options that can lead to inflated balances. Credit agreements often are incomprehensible. Lenders increasingly unbundle the loan costs from the interest rate into an array of fees and outsource their overhead to third parties, all of which adds to the consumer's cost. There is widespread concern that consumers cannot understand the terms of credit given these lender-created complexities and information asymmetries. Lenders exploit these deficiencies in ways that result in price gouging and predatory lending.

Nearly forty years ago, Congress addressed the problems caused by lack of transparency in credit pricing when it enacted TILA. TILA promotes informed consumer shopping and a level playing field for lenders by requiring standard disclosure of the cost of credit, most simply through the APR and the finance charges upon which the APR is based.

Regrettably, the value of the APR disclosure has deteriorated since 1968 due to exclusions from the finance charge definition added primarily by the Federal Reserve Board ("the Board"), the agency to which Congress granted the authority to implement TILA through regulation. For the first time, we document the history of this decline and describe the consequences of an APR disclosure that has become incrementally weaker as an indicator of the true cost of the credit. The Board's "fee-by-fee" approach encourages all lenders to "game" the system by unbundling the cost of loan originations into an increasing number of fees that are excluded from the disclosed finance charges.

This Article draws upon financial literacy, cognitive psychology, and behavioral economics literature to explain the need for a more effective APR. A "fee-inclusive" APR puts truth back into lending and better arms all consumers, regardless of their financial literacy, to decide when credit is appropriate for their needs.

We posit a simple litmus test for the finance charge that creates a more effective APR, derived from the plain language of the Act: "If the consumer were not obtaining, accessing, or repaying the extension of credit, would the consumer be paying the fee directly or indirectly?"<sup>2</sup> We discuss why this test is superior to other proposed definitions of the finance charge and respond to arguments that a fee-inclusive APR is unhelpful to consumers and harms the industry.

The Board is currently undertaking a sweeping overhaul of TILA disclosure regulations, including the finance charge definition. Given the state

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2 For examples of when a fee is paid directly versus indirectly, see *infra* Section VII.A.

of the credit marketplace, a robust APR is more critical now than it was in 1968.

## I. The Goals of TILA

In the 1960s, Congress concerned itself with two serious problems faced by consumers when shopping for credit: the non-standardized methods of computing interest that resulted in apples-to-oranges comparisons of rates and the fact that rates alone, in any event, did not reflect the full cost of credit, given the additional fees charged in connection with credit.<sup>3</sup> After several years of hearings, Congress passed the Truth In Lending Act in 1968 to “assure a meaningful disclosure of credit terms” so that consumers could comparison shop and avoid expensive and abusive credit.<sup>4</sup>

There was widespread agreement that some rates charged were shockingly high and some credit extended was harmful.<sup>5</sup> Nevertheless, the Act did not regulate or restrict the terms of credit. Rather, Congress created a disclosure regime to complement the existing substantive credit regulation embodied in state law.<sup>6</sup> Congress explicitly deferred to the states, expecting them to substantively regulate consumer credit.<sup>7</sup>

TILA announced another important goal: enhancing competition among creditors.<sup>8</sup> TILA assumes that competition related to the credit price tag is salutary for the national economy. Healthy competition, achieved through informed consumers, places all lenders on equal footing, promotes an efficient market, weeds out the dishonest lenders, and reduces high-cost credit.<sup>9</sup>

3 Kathleen E. Keest, *Whither Now? Truth in Lending in Transition—Again*, 49 CONSUMER FIN. L.Q. REP. 360, 361 (1995) (relying on Senator Douglas, the original proponent of TILA, who noted that some creditors “compound the camouflaging of credit by loading on all sorts of extraneous fees, such as exorbitant fees for credit life insurance, excessive fees for credit investigation, and all sorts of loan processing fees which rightfully should be included in the percentage rate statement so that any percentage rate quoted is meaningless and deceptive” (quoting 109 CONG. REC. 2027, 2029 (1963))).

4 15 U.S.C. § 1601(a) (2000).

5 See, e.g., *Consumer Credit Protection Act: Hearings Before the Subcomm. on Consumer Affairs of the H. Comm. on Banking & Currency on H.R. 11601*, 90th Cong. 142 (1967) [hereinafter *House Hearings*] (testimony of James L. Robertson, Vice Chairman, Board of Governors of the Fed. Reserve System) (paying \$300 for \$150 television set “is too much”); *id.*, at 70-71 (letter from George A. Ranney, Inland Steel to Representative Frank Annunzio (Aug. 3, 1967)) (credit extended to workers when it should have been withheld and that extension “serves to enhance the credit problems to which many employees find themselves subject”).

6 At the time of TILA’s enactment, most states still had usury limitations. *House Hearings*, *supra* note 5, at 139 (testimony of James L. Robertson).

7 S. REP. NO. 90-392, at 8 (1967) (expressing the Senate Banking Committee’s hope that state regulation will make TILA unnecessary).

8 15 U.S.C. § 1601(a) (2000); see also Matthew A. Edwards, *Empirical and Behavioral Critiques of Mandatory Disclosure: Socioeconomics and the Quest for Truth in Lending*, 14 CORNELL J.L. & PUB. POL’Y 199, 209-211 (2005) (stating TILA’s “ultimate goal of increasing market efficiency or competitiveness”).

9 See, e.g., H.R. REP. NO. 90-1040 (1967), as reprinted in 1968 U.S.C.C.A.N. 1962, 1970 (“Significantly, no one segment of the industry feels it can afford to reform itself by disclosing an annual percentage rate without incurring a competitive disadvantage. Clearly, the only solution is to

Supporters of the Act posited that TILA would not restrict the growth of consumer credit, which Congress deemed essential to the nation's economy.<sup>10</sup> Instead, TILA would stabilize the national economy by helping consumers be more conscious and rational in their credit decisionmaking.<sup>11</sup>

Since 1968, preemption of state usury and other consumer laws by Congress and the federal banking agencies has spurred deregulation at the state level.<sup>12</sup> Today, the consumer credit marketplace is governed almost exclusively by disclosure rules.<sup>13</sup> It matters more than ever that the disclosures be right because consumers cannot count on substantive rules to protect them from overreaching credit.

## II. The Central Role of the APR and Finance Charge Disclosures

TILA requires two key disclosures of the cost of credit: the APR and the finance charge.<sup>14</sup> That the the finance charge and the APR are critical is highlighted by the fact that the Act requires these two disclosures to be more conspicuously displayed than the other mandatory disclosures. The exact terms "finance charge" and "annual percentage rate" must be used.<sup>15</sup> "Without accurate disclosure of the APR, the borrower is unable to compare credit terms offered by other lenders, and a central purpose of TILA is defeated."<sup>16</sup>

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require by legislation that all creditors use the same method ...."); *id.* at 1999-2000 (Supplemental Views of Leonor K. Sullivan) ("Out of the operations of this legislation should come needed help to the decent elements in this vital industry in overcoming unfair and dishonest competition from an unscrupulous minority engaging in practices which too often discredit credit and dishonor its ethics."); S. REP. NO. 96-368, at 16 (1979), *as reprinted* in 1980 U.S.C.C.A.N. 236, 252 (crediting TILA with a reduction in high cost credit from 1969 to 1979).

10 *House Hearings*, *supra* note 5, at 2 (statement of Leonor K. Sullivan); *see also* S. REP. NO. 90-392, at 1 (1967).

11 As we write, the evidence that excessive borrowing can destabilize the national economy is abundant. *See, e.g.*, Edmund L. Andrews, *Fed Cuts Rate Half Point, and Markets Soar*, N.Y. TIMES, Sept. 19, 2007, at A1.

12 ELIZABETH RENUART & KATHLEEN E. KEEST, *THE COST OF CREDIT: REGULATION, PREEMPTION, AND INDUSTRY ABUSES* §§ 2.4, 3.1-3.15 (3d ed. 2005 & Supp.).

13 *See, e.g.*, GOV'T ACCOUNTABILITY OFFICE, GAO-06-929, *CREDIT CARDS: INCREASED COMPLEXITY IN RATES AND FEES HEIGHTENS NEED FOR MORE EFFECTIVE DISCLOSURE TO CONSUMERS* 6 (2006), available at <http://www.gao.gov/new.items/d06929.pdf> [hereinafter GAO CREDIT CARD REPORT] ("[T]he disclosures required under TILA and Regulation Z are the primary means under federal law for protecting consumers against inaccurate and unfair credit card practices."); Edwards, *supra* note 8, at 204 (stating that disclosure is the primary mechanism of federal credit regulation); Christopher L. Peterson, *Truth, Understanding, and High-Cost Consumer Credit: The Historical Context of the Truth in Lending Act*, 55 FLA. L. REV. 807, 881 (2003) (claiming that disclosure is the most prevalent form of credit regulation at both the federal and state levels). However, the Federal Reserve Board has issued two sets of proposed substantive rules relevant to mortgage and credit card lending in 2008. 73 Fed. Reg. 1672 (Jan. 9, 2008) (addressing mortgage loans by proposing amendments to Regulation Z); Press Release, Board of Governors of the Federal Reserve System (May 2, 2008), available at <http://www.federalreserve.gov/newsevents/press/bcreg/20080502a.htm> (addressing credit card lending by proposing amendments to Regulations AA, DD, and Z).

14 15 U.S.C. §§ 1605, 1606 (2000).

15 15 U.S.C. § 1632(a) (2000); Edwards, *supra* note 8, at 214.

16 *First Nat'l Bank v. Office of the Comptroller of the Currency*, 956 F.2d 1456, 1462 (8th Cir. 1992) (quoting the Comptroller of the Currency).

The finance charge is the sum, stated in dollars, of the cost of the loan. It includes both the interest scheduled to be earned over the loan term and fees charged in connection with the loan.<sup>17</sup> The finance charge gives consumers a gross total of the costs associated with the loan.

The APR is calculated based on the finance charge. The APR converts the finance charge into a percentage rate.<sup>18</sup> The APR, by transforming a dollar amount into a rate, scales the finance charge to the size of the loan and its term. The APR both bundles the fees with the interest rate and standardizes the rate over an annual term. Thus, a shopper can tell whether a two-week loan is cheaper than a six-month loan by looking at just one number. The APR provides a unitary shopping instrument.

For fixed-term loans, such as many mortgage and car loans, the APR closely reflects the true cost of the loan, i.e., interest plus fees, as an annualized rate, as long as the various loan fees are included in the finance charge.<sup>19</sup> On the other hand, when creditors “unbundle” their costs from the interest rate into discrete fees and exclude them from the finance charge, the APR becomes less comparable and less useful.<sup>20</sup>

For open-end credit, e.g., credit cards and home equity lines of credit—loans where the amount of the debt and the time to pay it off are not fixed at the outset—TILA does not require the inclusion of any fees in the APR at the outset.<sup>21</sup> Fees are presumed to be unknown. As a result, the APRs in advertisements, solicitations, and in the contract are nothing more than the periodic interest rate.<sup>22</sup> These advertised APRs do not include any fees, even

17 12 C.F.R. § 226.4 (2007).

18 15 U.S.C. § 1606(a) (2000).

19 The APR will be the same as the note interest rate if the lender does not impose fees that constitute “finance charges” under TILA. When the lender charges fees that meet the finance charge definition, the APR will be higher than the note interest rate. ELIZABETH RENUART & KATHLEEN KEEST, *TRUTH IN LENDING* § 3.2.3 (6th ed. 2007).

20 Keest, *supra* note 3, at 364. One limitation on the APR’s ability to reflect the true cost of credit for long-term loans, such as mortgages, is that borrowers do not necessarily hold loans until maturity. An APR that includes financed fees, which are “accrued” upfront rather than over time as interest is, understates the cost if repaid prior to the end of the scheduled term. Thus, the duration for which borrowers hold loans affects whether it is cheaper to pay more in financed fees, added to the loan principal (likely a better deal if the loan is held for longer), or more in the interest rate (likely a better deal if the loan is refinanced earlier). See, e.g., BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM & THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, JOINT REPORT TO THE CONGRESS CONCERNING REFORM TO THE TRUTH AND LENDING ACT AND THE REAL ESTATE SETTLEMENT PROCEDURES ACT 9 (1998), available at <http://www.federalreserve.gov/boarddocs/press/general/1998/19980717/default.htm> [hereinafter FRB/HUD REPORT]. Some lenders manipulate this dynamic by front-loading fees and then encouraging borrowers to refinance. RENUART & KEEST, *supra* note 12, § 6.1.1. Nonetheless, the concern about the effect on duration is largely irrelevant except for the most sophisticated shoppers. For one thing, we are notoriously bad at predicting our futures. REID HASTIE & ROBYN M. DAWES, *RATIONAL CHOICE IN AN UNCERTAIN WORLD: THE PSYCHOLOGY OF JUDGMENT AND DECISION MAKING* 205-206 (2001). For another, the APR need not be perfect. The APR need only be standardized and therefore comparable to function as intended.

21 15 U.S.C. § 1637(a) (2000); 12 C.F.R. § 226.6(a) (2007).

22 15 U.S.C. § 1637(a)(4) (2000); 12 C.F.R. § 226.6(a)(2) (2007).



those that lenders know will be charged, such as annual fees, or those that their business models predict and depend on, such as over-limit fees or late charges. Although the Board could require the disclosure of the actual average cost of credit, or a “typical” APR, it has chosen not to do so.<sup>23</sup>

As a partial remedy, borrowers are given an APR with their billing statements. This APR includes the interest rate and the fees that TILA defines as finance charges.<sup>24</sup> In this context, the fees imposed by the creditor are split into three categories: finance charge fees, which are included in the APR; “other” fees, which must be disclosed but are not included in the APR; and fees that do not fall into either category and thus may not be disclosed or included in the APR.<sup>25</sup> Consumers thus learn after the fact how much the credit has cost them (at least partially), and may be able to adjust future use accordingly.

TILA disclosures have been remarkably effective in educating consumers to pay attention to the APR as a key measure of the cost of credit.<sup>26</sup> Most consumers report looking for and using TILA’s standardized disclosures when

23 In comments filed with the Federal Reserve Board in March 2005, the National Consumer Law Center, joined by other organizations, proposed that a “typical” APR replace the “nominal” APR in credit card advertisements, solicitations, and at account opening. Comments Regarding Advance Notice of Proposed Rulemaking: Review of the Open-End (Revolving) Credit Rules of Regulation Z 41-43 (March 28, 2005), [http://www.consumerlaw.org/issues/credit\\_cards/content/open\\_end\\_final.pdf](http://www.consumerlaw.org/issues/credit_cards/content/open_end_final.pdf) (last visited July 6, 2007). This APR could be calculated as an average of the effective APRs charged existing customers over the previous year: the sum of all of the periodic statement APRs disclosed on the periodic billing statements over the last three years for all customers with credit card accounts of the same or similar product type to that being offered to the new customer, divided by the number of these effective APRs disclosed to these other customers. A typical APR would reflect the reality of credit card costs for the average consumer who uses it and thus permit consumers to shop for credit. See also BARRY NALEBUFF & IAN AYRES, WHY NOT? HOW TO USE EVERYDAY INGENUITY TO SOLVE PROBLEMS BIG AND SMALL 181 (2003) (arguing that credit card lenders should be required to disclose the chance that a consumer will incur a late fee at the time of application).

24 This APR is often referred to as the “effective” APR or “historic” APR, since it reflects the “effects” of the previous month’s charges. See *Examining the Current Legal and Regulatory Requirements and Industry Practices for Credit Card Issuers with Respect to Consumer Disclosures and Marketing Efforts: Hearing Before the S. Comm. on Banking, Housing, and Urban Development*, 109th Cong. 55 (2005) (statement of Edward M. Gramlich, Member, Board of Governors of the Federal Reserve System).

25 See 12 C.F.R. § 126.6, 6(a)-6(b) (Supp. 2007). For examples of “other” fees and fees that are neither finance charges nor “other” fees and therefore not disclosed, see *infra* Section IV.E.

26 S. REP. NO. 96-368, at 16 (1979), as reprinted in 1980 U.S.C.C.A.N. 236, 252 (citing Federal Reserve Board statistics showing an increase in awareness of the APR in the closed-end context from 15% before the enactment of TILA to 55% in 1977); Thomas A. Durkin, *Consumers and Credit Disclosures: Credit Cards and Credit Insurance*, FED. RES. BULL. 203, 206 (April 2002) (awareness of the APR in the credit card context rose from 27% before enactment of TILA to 91% by 2000; 76% of credit card holders surveyed in 2001 indicated that the APR was a very important credit term and another 19% responded that the APR was somewhat important).

shopping.<sup>27</sup> In credit markets where APRs are disclosed, more competition and lower credit prices result.<sup>28</sup>

For both closed-end and open-end credit, however, the usefulness of the APR as a shopping tool depends upon the uniform inclusion of all fees in the finance charge. This is why strict compliance with the finance charge disclosure is essential. Unless every lender includes all comparable fees on a consistent basis, consumers cannot use the APR to shop, and the core purpose of TILA unravels.<sup>29</sup>

The drafters of TILA understood that without uniform disclosure, interest calculations are forbiddingly complex.<sup>30</sup> The APR is meant to be a simplifying heuristic that allows borrowers to decide between options that are otherwise overwhelmingly complex.<sup>31</sup> Many consumers stumble when confronted with even basic computational problems.<sup>32</sup> Lenders can compound those missteps through marketing that distracts consumers from the salient points. Pricing must be uniform, without intermediate computational steps required for comparison.<sup>33</sup> The splintering of pricing into various fees and alternative pricing structures threatens the epistemological basis of truth in lending (TIL) disclosures.<sup>34</sup>

27 See, e.g., MACRO INT'L, INC., DESIGN AND TESTING OF EFFECTIVE TRUTH IN LENDING DISCLOSURES 9, 26 (2007), available at <http://www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf> (consumers look for the standardized open end TIL disclosure form known as the "Schumer box" and indicate that it is the most important part of a credit offer).

28 See Victor Stango & Jonathan Zinman, How a Cognitive Bias Shapes Competition: Evidence from Consumer Credit Markets 3-4 (Sept. 5, 2006) (unpublished manuscript, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=928956](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928956)) (stating that in markets where TILA disclosures are made reliably, consumers who most underestimate APRs given a payment stream do not overpay on credit; in markets where TILA disclosures are not made reliably, same consumers pay 200-400 basis points more for interest compared to consumers who underestimate APRs to a lesser degree).

29 See Edwards, *supra* note 8, at 226.

30 See *House Hearings*, *supra* note 5, at 76 (statement of Joseph W. Barr, Treasury Undersecretary) (stating that "[e]ven a financial expert" could not be relied on to compare how much interest was being charged by competing lenders); cf. S. REP. NO. 90-392, at 3 (1967) (discussing a survey of 800 families, which found that, on average, the cost of consumer credit was underestimated by nearly a factor of three). This has not changed, unfortunately. See WILLIAM C. APGAR & CHRISTOPHER E. HERBERT, U.S. DEP'T OF HOUSING AND URBAN DEV., SUBPRIME LENDING AND ALTERNATIVE FINANCIAL SERVICE PROVIDERS: A LITERATURE REVIEW AND EMPIRICAL ANALYSIS, at x (2006) ("[G]iven the . . . complexity of . . . the cost of [mortgages], even the most sophisticated borrower will find it difficult to evaluate mortgage options."); Jinkook Lee & Jeanne M. Hogarth, *Returns to Information Search: Consumer Credit Card Shopping Decisions*, 10 FIN. COUNSELING & PLAN. 23, 33 (1999) (finding that researchers have trouble determining payoff from shopping for credit cards, given complexity of pricing structure).

31 A heuristic is a decisionmaking shortcut, without reviewing or understanding all the nuances. Amos Tversky & Daniel Kahneman, *Judgment under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124, 1124 (1974).

32 For a full discussion of consumers' computational literacy limitations, see *infra* text accompanying notes 158-166.

33 S. REP. NO. 90-392, at 2 (1967) (discussing the difficulty many consumers had translating monthly rates into annual rates).

34 Cf. Peterson, *supra* note 13, at 901 ("[T]hese seemingly innocuous exceptions can completely undermine the whole transaction cost reducing value of Truth in Lending.").

In the next Part, we describe the state of affairs facing Congress in 1963-1968 that spurred it to act. We chronicle the changes to the credit marketplace since then and conclude that the need for a comprehensive APR is now greater than ever.

### III. Changing Lender Behavior and Its Effect on the Vitality of the APR

#### A. General Trends

When Congress passed TILA in 1968, legislators and witnesses discussed high rates of garnishment, shocking interest rates of 18%, a debt service equal to that of the nation's debt, and historically high bankruptcy filings.<sup>35</sup> The changes in the market since then cause some of us to look back on 1968 with nostalgic fondness.

Consumer credit and debt have exploded.<sup>36</sup> The bankruptcy rate increased more than six-fold between 1970 and 2005.<sup>37</sup> Consumers now report paying interest on their credit cards in excess of 30%.<sup>38</sup> Payday loans unabashedly sport price tags as high as 780%.<sup>39</sup>

In 1968, closed-end debt represented nearly 80% of all consumer debt.<sup>40</sup> Credit cards were new and most discussion of open-end debt involved retailers, not banks.<sup>41</sup> Home mortgages were relatively simple. Subprime lending, as we know it today, had not been invented.<sup>42</sup>

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35 See generally S. REP. NO. 90-392, at 2-4; *House Hearings*, *supra* note 5.

36 As of January 1969, outstanding consumer debt totaled approximately \$118 billion; this rose to \$2.456 trillion by July 2007, an increase in real terms of more than 400%. FEDERAL RESERVE, STATISTICAL RELEASE, CONSUMER CREDIT (2007), available at <http://federalreserve.gov/releases/g19/20070807/g19.pdf>.

37 Compare Elizabeth Warren, *A Principled Approach to Consumer Bankruptcy*, 71 AM. BANKR. L.J. 483, 488 n.12 (1997) (reporting that the personal bankruptcy rate in 1970 was .88 per 1,000 people) with Thomas A. Garrett, *The Rise in Personal Bankruptcies: The Eighth Federal Reserve District and Beyond*, 89 FED. RES. BANK OF ST. LOUIS REV., Jan. 2007, at 15, 15 (personal bankruptcy rate in 2005 was nearly 5.4 per 1,000 people), available at <http://research.stlouisfed.org/publications/review/07/01/Garrett.pdf>.

38 *Credit Cards: They Really Are Out to Get You*, CONSUMER REPORTS, Nov. 2005, at 12.

39 Edward Robinson, *JP Morgan, Banks Back Lenders Luring Poor with 780 Percent Rates*, BLOOMBERG.COM, Nov. 23, 2004, <http://www.bloomberg.com/apps/news?pid=nifea&sid=ayYDo5tpjTY8>.

40 H.R. REP. NO. 90-1040, at 7 (1967) as reprinted in 1968 U.S.C.C.A.N. 1962, 1968 (excluding mortgages for other than "repair and modernization").

41 Open-end, or revolving, credit is credit extended under a plan that "reasonably contemplates repeated transactions." 15 U.S.C. § 1602(i) (2000).

42 *Subprime Mortgage Market Turmoil: Examining the Role of Securitization—A Hearing Before the U.S. S. Comm. on Banking, Housing, and Urban Affairs Subcomm. on Securities, Insurance, and Investment*, 110th Cong. 2-8 (2007) (testimony of Christopher L. Peterson), available at [http://banking.senate.gov/public/\\_files/ACFE4F.pdf](http://banking.senate.gov/public/_files/ACFE4F.pdf).

Now, only 63% of non-mortgage debt has a fixed term.<sup>43</sup> Credit card debt is approximately 86% of revolving debt and by itself accounts for 30% of all non-mortgage consumer credit.<sup>44</sup> Between 1990 and 2005 alone, credit card debt increased 238%.<sup>45</sup> Home mortgage loan products now include both the traditional fixed-rate, fixed-term products plus a rising proportion of home equity lines of credit and complex “exotic” or “toxic” adjustable rate products.<sup>46</sup> Subprime lending, a more expensive form of traditional lending ostensibly aimed at homeowners with impaired credit, took off in 1994, with originations rising to \$625 billion by 2005 and accounting for one-fifth of total mortgage originations.<sup>47</sup>

Over the last twenty years, the lending industry has unbundled much of the cost of doing business from the interest rate to separate and oftentimes numerous fees. Fee revenue supplements the stream of income generated by the interest rate, leading to padded and junk fees as lenders search to increase the bottom line profits.<sup>48</sup>

## B. *The Unbundling and Proliferation of Fees*

### 1. Credit Cards

Credit cards, a tiny amount of the total consumer credit outstanding in 1967, have become ubiquitous. In 1970, two years after TILA’s enactment, only 16% of all families had a credit card.<sup>49</sup> As of 2004, 74.9% of all families

43 G.19 Fed. Res. Stat. Release (Aug. 7, 2007) (based on second quarter 2007 data), <http://federalreserve.gov/releases/g19/20070807/g19.pdf>.

44 Oct. Debt, CARDWEB.COM, Dec. 11, 2006, <http://www.cardweb.com/cardtrak/news/2006/december/11a.html>.

45 GAO CREDIT CARD REPORT, *supra* note 13, at 57.

46 See, e.g., Allen J. Fishbein & Patrick Woodall *Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders*, CONSUMER FED. OF AM. (May 2006), [http://www.consumerfed.org/pdfs/Exotic\\_Toxic\\_Mortgage\\_Report0506.pdf](http://www.consumerfed.org/pdfs/Exotic_Toxic_Mortgage_Report0506.pdf). The dollar volume of interest only mortgages and option ARMs increased from \$205 billion in 2004 to \$775 billion in 2006. INSIDE MORTGAGE FIN. PUBL’NS, INC., 1 MORTGAGE MARKET STATISTICAL ANNUAL 6 (2007).

47 EDWARD M. GRAMLICH, SUBPRIME MORTGAGES: AMERICA’S LATEST BOOM AND BUST 7 (2007). For an overview of the literature on subprime, much of it critical, see APGAR & HERBERT, *supra* note 30.

48 Keest, *supra* note 3, at 362; see also *Charter One Mortgage Corp. v. Condra*, 865 N.E.2d 602, 607 (Ind. 2007) (noting that the lender “says it charges these fees to recover embedded salary costs and to offset overhead associated with the preparation of a mortgage”); *Bank One, N.A. v. Velten*, 917 So. 2d 454, 462-63 (La. Ct. App. 2005) (discussing the various fees charged by the lender in addition to the interest rate on the 1999 loan of 9.363%, including loan discount fee (\$6,154), processing fee (\$425), tax service fee (\$97), flood certification fee (\$18); noting additional closing costs borne by the homeowner and paid to third parties, including abstract or title search fee (\$200), title exam fee (\$200), notary fee (\$200), appraisal fee (\$375), and document preparation fee (\$100)).

49 Thomas A. Durkin, *Credit Cards: Use and Consumer Attitudes, 1970-2000*, FED. RES. BULL. 623, 625 (Sept. 2000), <http://www.federalreserve.gov/pubs/bulletin/2000/0900lead.pdf>.

held some type of credit card.<sup>50</sup> While more people hold credit cards across all income segments of the population, the largest growth in credit-card holding has occurred among the poorest Americans.<sup>51</sup>

Until the mid-1990s, most card issuers only offered one interest rate and most of the pricing was contained in the interest rate.<sup>52</sup> The landscape is remarkably different now. Issuers typically charge at least three interest rates: one for purchases, one for balance transfers, and one for cash advances.<sup>53</sup> Many cards also offer initial low promotional rates, but charge significantly higher rates if the consumer is late or over-limit. These penalty rates are a growing portion of credit card lenders' income.<sup>54</sup> This complexity in interest pricing means that even consumers who shop around may not get the best deal.<sup>55</sup>

Fees increasingly drive consumers' costs.<sup>56</sup> Annual fees have now disappeared from some cards, but most other fees have become more expensive and more prevalent.<sup>57</sup> Card issuers now charge a bewildering array of fees

50 According to the Federal Reserve *Survey of Consumer Finances*, 95.4% of these cardholders hold a bank card. Thus, 71.5% of all families hold a bank issued credit card. Brian K. Bucks, Arthur B. Kennickell & Kevin B. Moore, *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances*, FED. RES. BULL. at A31 (Mar. 2006), <http://www.federalreserve.gov/pubs/bulletin/2006/financesurvey.pdf>.

51 Kathleen W. Johnson, *Recent Developments in the Credit Card Market and the Financial Obligations Ratio*, FED. RES. BULL. 473, 475 (Autumn 2005), <http://www.federalreserve.gov/pubs/bulletin/2005/05index.htm> (stating that between 1989 and 2001, the poorest one fifth of American households increased credit card holding by 46.5%, nearly five times the rate of all American households combined, and more than twenty times the rate for the top two fifths of all American households); see also Durkin, *supra* note 49, at 626 (indicating that in 1970, only 2% of the families in the bottom fifth by income had a bank issued credit card; by 1998, 28% of the poorest one fifth of families had a bank-issued credit card).

52 2005 BD. OF GOVERNORS OF FED. RES. SYS., ANN. REP 4-6 (2005) [hereinafter FRB PROFITABILITY REPORT], available at <http://www.federalreserve.gov/boarddocs/rptcongress/creditcard/2005/ccprofit.pdf>.

53 GAO CREDIT CARD REPORT, *supra* note 13, at 14; Mark Furletti & Christopher Ody, *Another Look at Credit Card Pricing and Its Disclosure. Is the Semi-Annual Pricing Data Reported by Credit Card Issuers to the Fed Helpful to Consumers or Researchers?* 7 (Fed. Reserve Bank of Phila., Payment Cards Ctr., Discussion Paper No. 06-08, 2006), available at <http://www.philadelphiafed.org/pcc/papers/2006/D2006JulyEvaluationofTCCPDataCover.pdf>.

54 The imposition of penalty rates may be triggered by late payments, running charges up over the credit limit, or a late payment or other default to a different creditor. GAO CREDIT CARD REPORT, *supra* note 13, at 24-26.

55 See MACRO INT'L, INC., *supra* note 27, at vii (noting that even borrowers who are aware of different rates do not understand how those rates would be applied); Lee & Hogarth, *supra* note 30, at 32-34 (discussing how consumers who shop generally get lower APRs for purchases, but fewer consumers shop on other pricing factors including the grace period, late fees, and cash advance APRs; no data as to what the total cost of credit is including the non-APR pricing factors).

56 See *Improving Federal Consumer Protection in Financial Services: Hearing Before the H. Comm. on Financial Services*, 110th Cong. app. 94-95 (2007) (statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation) (noting that net non-interest income for insured institutions has been growing faster than total net operating revenue).

57 Ashish Rajan, *Card Fees*, CARDTRAK.COM, July 18, 2006, <http://www.cardweb.com/cardtrak/news/2006/july/18a.html> (stating that late fees have soared by 137% in the last ten years); Julia Spences, *Over-Limit Fees*, CARDTRAK.COM, Feb. 6, 2006, <http://www.cardweb.com/cardtrak/news/2006/february/6a.html> (stating that over-limit fees increased between 1994 and 2005 by 96%).

depending on the product and its usage, including annual, set-up, replacement card, late, over-limit, balance transfer, cash advance, phone payment convenience, expedited payment, foreign transaction, returned check, wire, credit protection, and inactivity fees.<sup>58</sup> As described later in this Article, the Board excluded most of these fees from the finance charge over the years.<sup>59</sup>

Pricing variability extends far beyond interest and fees. The creditor's choice of payment allocation, interest compounding, and single or double cycle billing cycles, among other "computational techniques," can significantly affect the total cost of credit.<sup>60</sup>

Even consumers with high levels of financial literacy cannot parse credit card pricing.<sup>61</sup> The Board's exclusion of many of the industry's fees from the finance charge undermines the accuracy, as originally intended, of the APR disclosure. The result is a loss of competition among card-issuers.<sup>62</sup>

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58 See, e.g., *Examining the Billing, Marketing, and Disclosure Practices of the Credit Card Industry, and Their Impact on Consumers: Hearing Before the S. Comm. on Banking, Housing & Urban Affairs*, 110th Cong. 7-10 (2007) (testimony of Michael D. Donovan, Partner, Donovan Searles, LLC) (citing "credit protection fee"); *Card Companies Use Common "Risk Factors" to Impose Unfair Rate Hikes, Finds CA*, CONSUMER ACTION NEWS, Summer 2005, at 1-2, available at [http://www.consumer-action.org/news/articles/2005\\_credit\\_card\\_survey/#Topic\\_06](http://www.consumer-action.org/news/articles/2005_credit_card_survey/#Topic_06); Fed. Reserve Bd., *Choosing a Credit Card*, <http://www.federalreserve.gov/pubs/shop> (last visited May 5, 2008); Mark Furletti, *Credit Card Pricing Developments and Their Disclosure* 10-13 (Payment Cards Ctr., Fed. Reserve Bank of Phila., Discussion Paper No. 03-02, 2003), available at [http://www.philadelphiafed.org/pcc/papers/2003/CreditCardPricing\\_012003.pdf](http://www.philadelphiafed.org/pcc/papers/2003/CreditCardPricing_012003.pdf) (separating fees into two categories, risk-based and convenience-based, and listing some common fees).

59 See *infra* text accompanying notes 110-140. Cash advance, inactivity, balance transfer, and inactivity fees remain finance charge fees.

60 Furletti, *supra* note 58, at 15-17; see also MACRO INT'L, INC., *supra* note 27, at v-vi (noting that consumers do not understand the balance calculation method, payment allocation method, or grace period, even when explained in disclosures).

61 See Ronald J. Mann, "Contracting" for Credit, 104 MICH. L. REV. 899, 914-15 (2006) (describing how complexity, segmentation, and unilateral modification of terms combine to prevent increased consumer sophistication from reducing profits or increasing market efficiency); Comments of the Ctr. for Responsible Lending on Advance Notice of Proposed Rule-Making, Regulation Z, Subpart B: Open-End Credit 22 (Mar. 28, 2005), [http://www.responsiblelending.org/pdfs/Comment\\_FRB032805.pdf](http://www.responsiblelending.org/pdfs/Comment_FRB032805.pdf) ("[C]ollege-educated consumers consistently underestimate[] how long it would take to pay off credit card balances."); cf. Sumit Agarwal et al., *Do Consumers Choose the Right Credit Contracts?* 16 (Rodney L. White Ctr. for Fin. Research, The Wharton Sch., Univ. of Pa., Working Paper No. 36-05, 2005) (finding that wealthy borrowers showed a similar pattern of errors in credit card usage as compared to less wealthy borrowers).

62 See *Credit Card Practices: Fees, Interest Rates, and Grace Periods: Hearing Before the Subcomm. on Investigations of the S. Comm. on Homeland Security and Governmental Affairs*, 110th Cong. 13 (2007) [hereinafter *Credit Card Hearings*] (testimony of Alys Cohen, Staff Attorney, National Consumer Law Center) ("Consumers have little or no meaningful choices on the terms that create the bulk of the cost of credit card debt."); Ronald J. Mann, *Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007 U. ILL. L. REV. 375, 385 (stating that the top five issuers hold more than 70% of credit card debt).

## 2. Mortgage Lending

In 1968, home mortgage interest rates were largely uniform. A consumer either qualified for a prime mortgage or none at all.<sup>63</sup> Although some witnesses at the congressional hearings on TILA expressed concern over fee proliferation, regional differences in pricing, and disclosure of real estate fees, fees were still a relatively small part of pricing.<sup>64</sup>

In stark contrast to 1968, interest rates now vary widely based on a variety of factors.<sup>65</sup> Some of these variables are within the borrowers' control or knowledge, such as the credit score; others are not, such as undisclosed compensation to the broker.<sup>66</sup> Subprime lending occupies an increasingly large share of the market for both home purchase and refinance loans.<sup>67</sup> A range of adjustable rate products, variously labeled "alternative," "exotic," and "nontraditional," poorly understood even by lenders, make up a growing share of the mortgage market.<sup>68</sup>

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63 See *House Hearings*, *supra* note 5, at 133 ("[I]n a normal home purchase transaction, a person would buy at the going rate of interest, whether it be through a savings and loan or through a bank . . .") (statement of Rep. Sullivan, Member, H. Comm. on Banking and Currency); cf. Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. ON LEGIS. 123, 125-26 (2007) (describing "the old world of average-cost pricing").

64 Compare *House Hearings*, *supra* note 5, at 82-84 (statement of Joseph W. Barr, Under Secretary, Department of the Treasury) (arguing for standardized disclosure of costs in mortgage loans since consumers are confused by points and regional pricing differences for closing costs and other fees), with *id.* at 126, 139 (statement of James L. Robertson, Vice Chairman, Board of Governors of the Fed. Reserve System) (arguing that new disclosures for first mortgage loans were unnecessary, as fees were uniformly disclosed and relatively small compared to interest costs, which were standard).

65 See, e.g., Alan M. White, *Risk-Based Mortgage Pricing: Present and Future Research*, 15 HOUSING POL'Y DEBATE 503, 513 (2004) (noting that interest rates for 15-year mortgages in April 2003 ranged from 5%, for prime mortgages, to 20%, for subprime mortgages). One of the most troubling and persistent variables of mortgage interest pricing remains race, even accounting for credit risk factors. For a review of much of the literature exploring the relationship between pricing and race, see APGAR & HERBERT, *supra* note 30, at 1-12 to -15. See also DEBBIE GRUENSTEIN BOCIAN, KEITH S. ERNST & WEI LI, CTR. FOR RESPONSIBLE LENDING, UNFAIR LENDING: THE EFFECT OF RACE AND ETHNICITY ON THE PRICE OF SUBPRIME MORTGAGES 7 (2006), [http://www.responsiblelending.org/pdfs/tr011-Unfair\\_Lending-0506.pdf](http://www.responsiblelending.org/pdfs/tr011-Unfair_Lending-0506.pdf) (discussing how after controlling for individual loan characteristics, significant price disparities by race remain).

66 See White, *supra* note 65, at 509 (rate sheets not publicly available in the subprime mortgage market); John R. Wilke, *Hidden Fees in Most Mortgages Bring Scrutiny to Fannie, Freddie*, WALL ST. J., Jan. 14, 2005, at A1 (reporting on guarantee fees paid by lenders to Fannie Mae and Freddie Mac that are packaged in the interest rate and undisclosed to borrowers, averaging two-tenths of a percent of the loan amount per month).

67 See, e.g., JIM CAMPEN, MASS. COMM. & BANKING COUNCIL, BORROWING TROUBLE VII: HIGHER-COST MORTGAGE LENDING IN BOSTON, GREATER BOSTON AND MASSACHUSETTS, 2005, at 5 (2007), <http://www.masscommunityandbanking.org/PDFs/BorrowingTrouble7.pdf> (stating that in 2005, 25.6% of all home purchase mortgages and 17.1% of all refinance loans in Massachusetts were high cost, a proxy for subprime lending).

68 See, e.g., GOV'T ACCOUNTABILITY OFFICE, ALTERNATIVE MORTGAGE PRODUCTS: IMPACT ON DEFAULTS REMAINS UNCLEAR, BUT DISCLOSURE OF RISKS TO BORROWERS COULD BE IMPROVED 4 (2006), available at <http://www.gao.gov/new.items/d061112t.pdf> (stating that interest-only and payment option mortgages grew between 2003 to 2005 from less than 10% of the market to 30% of the market); Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609, 58,616 (Oct. 4, 2006) (expressing concern that neither lenders nor consumers understand these products, and suggesting

Mortgage lenders now charge a dizzying array of fees.<sup>69</sup> Lenders and third parties may both charge fees for the same activities. For example, brokers and lenders both may be compensated by fees for checking a borrower's credit, preparing documents, or reviewing the loan application. Broker compensation is particularly opaque. Consumers may pay brokers as many as three times: first, with cash out of pocket; second, with financed fees paid from the loan proceeds; and third, with an increased interest rate to cover any lender-paid broker compensation.<sup>70</sup> Lenders pass these fees onto the consumer, often without consistently including them in or excluding them from the price tag TIL disclosures.<sup>71</sup>

The lender-created complexity of mortgage loans now exceeds what most consumers, even highly educated consumers, are capable of comprehending.<sup>72</sup> Lenders possess much more extensive experience with home mortgage loans than do even sophisticated borrowers. Lenders also have more knowledge of the borrower's risk of default than does the borrower.<sup>73</sup> This information

that lenders "should recognize that their limited performance history with [nontraditional mortgages] increases performance uncertainty," and "consumers may not fully understand these products").

69 See, e.g., JAMES M. LACKO & JANIS K. PAPPALARDO, FED. TRADE COMM'N, IMPROVING CONSUMER MORTGAGE DISCLOSURE: AN EMPIRICAL ASSESSMENT OF CURRENT AND PROTOTYPE DISCLOSURE FORMS 32 (2007), available at <http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf> [hereinafter FTC DISCLOSURE REP.] (respondent with master's degree could guess what less than half of what twelve listed charged fees were for); Peterson, *supra* note 13, at 899-902 (describing movement in the mortgage context from "points" to a variety of "junk fees"); Elizabeth Renuart, *An Overview of the Predatory Mortgage Lending Process*, 15 HOUSING POL'Y DEBATE 467, 493 (2004) (listing fees including "loan origination, loan discount, appraisal, credit report, lender's inspection, YSP, underwriting, processing, warehousing, mailing, wire, signing, credit insurance premium, settlement/closing, abstract title search, title examination, title insurance binder, title insurance premium, document preparation, notary, recording, courier, and fax fees"); Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 725-728 (2006).

70 See KEITH ERNST, DEBBIE BOCIAN & WEI LI, CTR. FOR RESPONSIBLE LENDING, STEERED WRONG: BROKERS, BORROWERS, AND SUBPRIME LOANS 8-9 (2008), available at <http://www.responsiblelending.org/pdfs/steered-wrong-brokers-borrowers-and-subprime-loans.pdf> (describing broker compensation as two channels, an origination fee and a yield spread premium).

71 Keest, *supra* note 3, at 362.

72 APGAR & HERBERT, *supra* note 30, § 2.2.3, at 1-15 (2006) ("Unfortunately, given the bewildering array of mortgage products available, even the most sophisticated borrower will find it difficult to evaluate the details of a mortgage."); cf. FTC DISCLOSURE REP., *supra* note 69, at ES-11 (stating that prime borrowers have difficulty answering questions about their loans; difficulty increases as loan becomes more complex).

73 Donald P. Morgan, *Defining and Detecting Predatory Lending 2* (Fed. Reserve Bank of N.Y., Staff Report No. 273, Jan. 2007), available at [http://www.newyorkfed.org/research/staff\\_reports/sr273.pdf](http://www.newyorkfed.org/research/staff_reports/sr273.pdf); cf. Jason J. Kilborn, *Behavioral Economics, Overindebtedness & Comparative Consumer Bankruptcy: Searching for Causes and Evaluating Solutions*, 22 EMORY BANKR. DEV. J. 13, 16-22 (2005) (explaining that lenders exploit consumers' psychological biases to induce borrowing); Mann, *supra* note 61, at 379 (arguing that credit card lobbyists pushed for the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act as a calculated strategy to "slow the time of inevitable filings by the deeply distressed, allowing issuers to earn more revenues from these individuals before they file.").



asymmetry has helped fuel predatory lending and likely pushed many borrowers into default and foreclosure.<sup>74</sup>

### 3. "Fringe" Lending

The "fringe" lending market consists of smaller-sum, shorter-term loans that have appeared on the scene in large volume since the late 1980s. These products include: payday, tax refund anticipation (RAL), and overdraft loans; pawns and auto title pawns for cash advances; and rent-to-own products for retail sale.<sup>75</sup> For these products, there are often no TIL signposts, pricing distortions are rife, and comparison shopping becomes impossible. Unsurprisingly, the actual APRs for these products are correspondingly high.

For example, the Board has exempted most rent-to-own contracts, a common form of financing in poor communities for durable goods purchases, from APR disclosures.<sup>76</sup> Many a love seat and refrigerator has been carried through that loophole, without any disclosure of the cost of the credit extended.

In auto title lending, where the security is the title to a car, APRs are commonly undisclosed before consummation of the loan.<sup>77</sup> Instead, lenders disclose weekly, biweekly or monthly interest rates.<sup>78</sup> Reported APRs in states with rate caps are commonly in the 200% to 300% range, although, when the APR is calculated correctly, including all fees, many of these loans have actual

74 See Philip Bond, David K. Musto & Bilge Yilmaz, *Predatory Lending in a Rational World* 3-4 (Fed. Reserve Bank of Phila. Working Paper No. 06-2, 2006), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=875621](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=875621). Foreclosure rates have skyrocketed since the time of TILA's enactment. Between the 1980s and 1990s, the foreclosure rate increased over 300%. Peter Elmer & Steven A. Seelig, *The Rising Long-Term Trend of Single Family Mortgage Foreclosure Rates* 1, (FDIC Working Paper No. 98-2, 1998), available at <http://www.fdic.gov/bank/analytical/working/98-2.pdf>. Much of the increased rate of foreclosure in recent years is attributable to the growth of subprime lending and nontraditional mortgage products. ELLEN SCHLOEMER ET AL., CTR. FOR RESPONSIBLE LENDING, LOSING GROUND: FORECLOSURES IN THE SUBPRIME MARKET AND THEIR COST TO HOMEOWNERS 21 (2006), available at <http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf>.

75 See Lynn Drysdale & Kathleen Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and its Challenge to Current Thinking About the Socio-Economic Role of Usury Law*, 51 S.C. L. REV. 589 (2000) (defining the term "fringe" lending and detailing the rise of this market).

76 The regulations provide that if the lease is terminable without penalty by the consumer, the transaction is excluded from TILA's coverage. 12 C.F.R. § 226.2(a)(16) (2007). The Board's authority to issue this regulation was upheld in *Ortiz v. Rental Management, Inc.*, 65 F.3d 335 (3d Cir. 1995). Ironically, the Vice Chairman of the Federal Reserve Board expressed concern over precisely this kind of financing during the 1967 hearings on TILA. *House Hearings*, *supra* note 5, at 142 (testimony of James L. Robertson, Vice Chairman, Board of Governors of the Fed. Reserve System).

77 JEAN ANN FOX & ELIZABETH GUY, CONSUMER FED'N OF AM., DRIVEN INTO DEBT: CFA CAR TITLE LOAN STORE AND ON-LINE SURVEY 14, 33 (2005), available at [http://www.consumerfed.org/pdfs/Car\\_title\\_Loan\\_Report\\_111705.pdf](http://www.consumerfed.org/pdfs/Car_title_Loan_Report_111705.pdf) (describing that of seventeen online title lenders surveyed, only five quoted fee inclusive APRs). Lenders often attempt to characterize auto-title loans as sale-leaseback transactions or open-end credit in order to avoid disclosure requirements. RENUART & KEEST, *supra* note 12, § 2.5.2.

78 Fox & Guy, *supra* note 76, at 14.

APRs much higher.<sup>79</sup> Some reported cases reveal APRs of over 900% when the APR is calculated correctly.<sup>80</sup>

Payday lenders typically disclose the APR in the loan documents. The Board, however, has exempted payday lending's closest competitor, overdraft loans made by banks, from TILA coverage entirely.<sup>81</sup> Thus, a borrower, deciding between dipping into overdraft "protection" and signing up for a payday loan, can only compare the fees, not a standardized APR.<sup>82</sup>

Finally, the Board permits RAL lenders to pretend that the loan term is one year, rather than its actual ten day or two week term.<sup>83</sup> As a result, the APRs on RALs may be dramatically understated.<sup>84</sup>

In the fringe lending market, the Board's abnegation of its responsibility to provide shopping guideposts to consumers is stark. Market distortions, such as that between payday and overdraft loans, are encouraged by the lack of consistency in TILA's implementation. Unfortunately, the carve-outs are more the Board's rule than its exception, as we discuss next.

79 AMANDA QUESTER & JEAN ANN FOX, CTR. FOR RESPONSIBLE LENDING & CONSUMER FED'N OF AM., *CAR TITLE LENDING: DRIVING BORROWERS TO FINANCIAL RUIN* 6 (2005), available at [http://www.responsiblelending.org/pdfs/r008-Car\\_Title\\_Lending-0405.pdf](http://www.responsiblelending.org/pdfs/r008-Car_Title_Lending-0405.pdf) (reporting that APRs in states without rate caps routinely reach 800%).

80 *E.g.*, *Pendleton v. Am. Title Brokers, Inc.*, 754 F. Supp. 860 (S.D. Ala. 1991). The lender in this case did not disclose any APR or interest rate, and the court did not calculate one. The lender contended that the auto-title pawn was a lease transaction, not a loan, and so the lender was not required to provide any TIL disclosures. The court found that auto-title pawn was a loan and that the lender had failed to disclose the finance charge. Since consumers can only recover damages once, regardless of how many different ways the lender fails to properly disclose the cost of credit, the court did not need to determine what the APR was. The calculation of the APR is that of the authors, based on the reported payment (\$22.88 a week), the amount of the loan (\$100), and the term of the loan (ten weeks).

81 *Truth in Savings*, 70 Fed. Reg. 29,582 (May 24, 2005).

82 *See* APGAR & HERBERT, *supra* note 29, at xiii (suggesting that payday loan borrowers may focus on dollar costs rather than APRs since the costs associated with returned checks are expressed in dollar costs).

83 *Truth in Lending* (Regulation Z), 12 C.F.R. pt. 226, supp. I, § 226.17(c)(1) cmt. 17 (2007) (Official Staff Interpretations) (providing that RALs may be disclosed as demand obligations); *Truth in Lending* (Regulation Z), 12 C.F.R. pt. 226, supp. I, § 226.17(c)(5) cmt. 1 (2007) (Official Staff Interpretations) (noting that demand obligations are to be disclosed as having a term of one year); RENUART & KEEST, *supra* note 19, § 4.4.10.2 (disclosing RAL terms and noting that most RALs are repaid at the time consumers receive their refund, typically ten days later).

84 *See, e.g.*, *Cades v. H & R Block, Inc.*, 43 F.3d 869, 875 (4th Cir. 1994) (upholding, based on the Board's Official Staff Interpretations, APR calculated as if the loan came due after 12 months; had APR been disclosed over actual three week term, APR would have been more than 17 times disclosed APR of 2.406%). For RALs, as for other loans, the key weakness of the APR continues to be the failure to include all costs of the loan in the finance charge. CHI CHI WU, NAT'L CONSUMER LAW CTR. & JEAN ANN FOX, CONSUMER FED'N OF AM., *ONE STEP FORWARD, ONE STEP BACK: PROGRESS SEEN IN EFFORTS AGAINST HIGH-PRICED REFUND ANTICIPATION LOANS, BUT EVEN MORE ABUSIVE PRODUCTS INTRODUCED* 9-10 (2007), available at [http://www.consumerlaw.org/issues/refund\\_anticipation/content/2007\\_RAL\\_Report.pdf](http://www.consumerlaw.org/issues/refund_anticipation/content/2007_RAL_Report.pdf) (finding that H&R Block, the cheapest major provider of RALs, in 2007 disclosed an APR of 36%; the actual APR on a loan of average size and duration was 85%, once various fees were included).

#### IV. The Evolution of the APR and the Finance Charge

In this Part, we chronicle the relevant amendments made by Congress and those generated by the Board and its Staff.<sup>85</sup> TILA itself contains a limited number of statutory exclusions from the finance charge. Congress granted the Board authority to create exceptions and adjustments for any class of transactions, so long as these determinations are “necessary or proper to effectuate the purposes of . . . [TILA], to prevent circumvention or evasion thereof, or to facilitate compliance therewith.”<sup>86</sup>

In the ensuing years, however, the value of the APR eroded through Board and staff line-drawing expressed in Regulation Z and the Commentary. The Board and its staff employ a fee-by-fee approach and, more often than not, have added exclusions to the finance charge. This trend reduces transparency, complicates compliance, and hinders rather than furthers the purposes of TILA.<sup>87</sup>

##### A. *The Original Statutory Definition of the Finance Charge*

The definition of a finance charge in the 1968 Act was broad.<sup>88</sup> The finance charge was “the sum of all charges, payable directly or indirectly by the person to whom the credit is extended, and imposed directly or indirectly by the creditor as an incident to the extension of credit.”<sup>89</sup>

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<sup>85</sup> Congress delegated authority for the implementation of TILA to the Board. 15 U.S.C. § 1604(a) (2000). Accordingly, the Board issued Regulation Z and amends it from time to time. Since 1981, the Staff to the Board publishes Official Staff Interpretations to Regulation Z, designed to clarify the intent of Regulation, provide examples of its proper application, and, at times, create rules where they did not otherwise exist. RENUART & KEEST, *supra* note 19, § 1.4.3.

<sup>86</sup> 15 U.S.C. § 1604(a) (2000).

<sup>87</sup> The Board admits that it contributed to the “swiss cheese” definition, although it places some blame on Congress. See FRB/HUD REPORT, *supra* note 20, at 8; see also Truth in Lending, 72 Fed. Reg. 32,948, 32,964 (June 14, 2007) (“[I]t is not clear that fee-by-fee guidance is sufficient to both facilitate compliance by credit card issuers and promote understanding by consumers.”).

<sup>88</sup> See RALPH J. ROHNER & FRED H. MILLER, TRUTH IN LENDING ¶ 3.02[1] (2000) (stating that the definition is initially all-inclusive and that “[t]he major feature of the definition of the cost of credit is that it is virtually impossible for the creditor to manipulate it”); Ralph J. Rohner & Thomas A. Durkin, TILA “Finance” and “Other” Charges in Open-End Credit: *The Cost-of-Credit Principle Applied to Charges for Optional Products or Services*, 17 LOY. CONSUMER. L. REV. 137, 172-177 (2005) (recognizing the general approach of the Act as “all-inclusive” and that “the core of that definition has not changed since 1968,” though proposing a finance charge definition not supported by the Act). When Professor Rohner and economist Durkin published the article cited above, the Board had begun its current overhaul of Regulation Z. In this article, the authors advocate for a revised definition of the finance charge, at least for “optional” charges. See *id.* at 201-05. Durkin was then and still is a staff economist at the Federal Reserve in Washington, D.C. Although Durkin asserts that he does not speak for the Board, his public advocacy for a particular interpretation of TILA in a matter pending before the Board is troubling to us, especially where the Board cited to and relied upon another article by that same author discussing credit card use and consumer attitudes in its Advance Notice of Proposed Rulemaking. *Id.* at 137 n.aal; see Truth in Lending, 69 Fed. Reg. 70,925, 70,927 n.2 (Dec. 8, 2004).

<sup>89</sup> Pub. L. No. 90-321, § 106(a), 82 Stat. 146, 178 (1968).

Congress recognized that effective disclosure required the uniform inclusion in the finance charge and APR of all credit-related fees regardless of whether the charges were retained by the creditor.<sup>90</sup> An example of a third-party finance charge in the original Act was a finder's fee.<sup>91</sup> The finance charge was a measure of the cost of credit to the consumer, not of compensation to the creditor.<sup>92</sup>

Section 106 of the 1968 Act<sup>93</sup> follows the general definition with examples of covered fees.<sup>94</sup> Sections 106(b) and (c) itemize fees that fall within the definitional construct but may be excluded if certain conditions are met.<sup>95</sup> Finally, the statute lists charges that are automatically excluded.<sup>96</sup> The

90 H.R. REP. NO. 90-1040 (1967), as reprinted in 1968 U.S.C.C.A.N. 1962, 1970-71, 1980. One of the main proponents of the Act, Senator Proxmire, spoke at some length about the principles represented in the statutory provisions:

The first principle of the bill is to insure that the American consumer is given the whole truth about the price he is asked to pay for credit. The bill would not regulate interest charges, but would rather aim at a full disclosure of the cost of credit so that the consumer can make an intelligent choice in the marketplace. . . . The second principle is that the whole truth about the cost of credit really is not meaningfully available unless it is stated in terms that consumers in our society can understand. Just as the consumer is told the price of milk per quart and the price of gasoline per gallon, so must the buyer of credit be told the "unit price." Historically, in our society that unit price for credit has been the annual rate of interest or finance charge applied to the unpaid balance of the debt. Without easy knowledge of this unit price for credit, it is virtually impossible for the ordinary person to shop for the best credit buy. . . . A third principle is that the definition of finance charge, upon which an annual percentage rate is calculated, needs to be comprehensive and uniform. It needs to be uniform to permit a meaningful comparison between alternative sources of credit. . . . The definition of finance charge also needs to be comprehensive in order to convey the true cost of credit . . .

90 Cong. Rec. S2042 (daily ed. Jan. 31, 1967) (statement of Sen. Proxmire).

91 Pub. L. No. 90-321, § 106(a), 82 Stat. 146, 148 (codified as amended at 15 U.S.C. § 1605(a) (2000)). Another example is a credit insurance premium, which is a finance charge if certain prerequisites are not met. *Id.* § 106(b), 82 Stat. at 148.

92 The Board confirmed this reading of the finance charge definition in the model forms it crafted to ease creditor compliance. *See, e.g.*, 12 C.F.R. § 226.18 app. H-1 (describing the "finance charge" as "[t]he dollar amount the credit will cost you"); *see also* FRB/HUD REPORT, *supra* note 20, at 8-16. In describing the purposes of the key dollar (finance charge) and rate (APR) disclosures, the agencies stated, "The idea was to capture the *cost of credit* in whatever form imposed by the creditor or paid by the borrower." *Id.* at 8.

93 15 U.S.C. § 1605 (2000).

94 § 106(a), 82 Stat. at 148. The examples of finance charges listed in § 106(a) are:

- 1) Interest, time price differential, and any amount payable under a point, discount, or other system of additional charges.
- 2) Service or carrying charge.
- 3) Loan fee, finder's fee, or similar charge.
- 4) Fee for an investigation.
- 5) Premium or other charge for any guarantee or insurance protecting the creditor against the obligor's default or other credit loss.

*Id.*

95 The fees identified in these subsections are: 1) "Charges or premiums for credit life, accident, or health insurance written in connection with any consumer credit transaction," *id.* § 106(b), and 2) "Charges or premiums for insurance, written in connection with any consumer credit transaction, against loss of or damage to property or against liability arising out of the ownership or use of property." *Id.* § 106(c).

96 § 106(d), (e), 82 Stat. at 148-149. The exclusions are: 1) "[f]ees and charges prescribed by law which actually are or will be paid to public officials for determining the existence of or for perfecting or releasing or satisfying any security related to the credit transaction;" 2) "[t]he premium payable for any insurance in lieu of perfecting any security interest otherwise required by the creditor if the premium does not exceed the legal amount;" 3) "[t]axes;" 4) "[a]ny other type of charge which is not

architecture of the Act presumes the inclusion of fees in the finance charge and limits the exclusion of fees to those listed.

## B. *Changes to the Statutory Definition Since 1968*

The core definition has remained the same since 1968.<sup>97</sup> However, Congress clarified it in 1980 and carved out significant exceptions in 1995.<sup>98</sup> The 1980 modifications were wrapped up in much larger, sweeping amendments to TILA, known as the Truth in Lending Simplification and Reform Act.<sup>99</sup> During its first ten years, the Act was credited with increasing consumer awareness of the annual percentage rate and a substantial reduction of the market share of creditors charging the highest rates.<sup>100</sup> Nevertheless, the lending industry expressed concern due to the spawn of administrative opinions and informal letters interpreting the Act issued by the Federal Reserve Board and its staff in the 1970s and the alleged difficulties of compliance.<sup>101</sup> As a result, Congress took a much leaner approach to almost every significant disclosure required by the Act, except the APR and finance charge.

Congress made two relevant changes to the finance charge definition. First, it clarified the definition by excluding fees “payable in a comparable cash transaction.”<sup>102</sup> This addition embodied common sense: sales taxes and license and registration fees, whether paid by cash or credit, are not charged “in

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for credit and the exclusion of which from the finance charge is approved by the Board by regulation;” and 5) real estate transaction related fees for a title examination, abstract, title insurance, property surveys, document preparation, an appraisal, a credit report, a notary, and the escrow for future payments of taxes and insurance. *Id.*

97 Compare *id.* § 106(a), with 15 U.S.C. § 1605(a) (2000). See also Rohner & Durkin, *supra* note 88, at 176.

98 Congress added a provision in 1974 (amended in 1981) to address discounts for payments by cash as part of the Fair Credit Billing Act amendments to TILA. Pub. L. No. 93-495, 88 Stat. 1511 (1974). Section 167(b) permitted cash discounts that did not exceed 5% to be excluded from the finance charge if offered by the seller for the purpose of inducing payment by cash, check or other means not involving the use of a credit card, if the discount is offered to all prospective buyers and its availability is disclosed clearly and conspicuously. 88 Stat. at 1515. The purpose behind the amendment was to encourage merchants to provide cash discounts without triggering TIL consequences for the card issuer. S. REP. NO. 92-750h, at 6 (1972); S. REP. NO. 97-23, at 1-2 (1981), as reprinted in 1981 U.S.C.C.A.N. 74, 74-75. Congress amended this section in 1981 to remove the 5% cap, thereby excluding a cash discount in any amount from the finance charge if the discount is offered to all prospective buyers and its availability is disclosed clearly and conspicuously. These amendments were codified at 15 U.S.C. § 1666f (2000). Cash Discount Act, Pub. L. No. 97-25, § 103, 95 Stat. 144, 144 (1981).

99 Pub. L. No. 96-221 tit. VI, 94 Stat. 132, 168 (1980).

100 S. REP. NO. 96-368, at 16 (1979), as reprinted in 1980 U.S.C.C.A.N. 236, 252.

101 *Id.* Another stated reason for the changes was to “simplify” the “informational overload.” *Id.* at 281-282. Consumers did not play a driving force in the effort to change TILA. See *Oversight Hearings Before the Subcomm. on Consumer Affairs of the H. Comm. on Banking, Financing, and Urban Affairs*, 95th Cong. 1 (1978) (statement of Rep. Annunzio, Chairman, Subcomm. on Consumer Affairs).

102 Pub. L. No. 96-221 tit. VI, § 606, 94 Stat. 170 (1980).

connection with the extension of credit.” Second, Congress required that non-finance charges in the open-end context—“other” charges—be identified.<sup>103</sup>

Congress was quiet on the finance charge front for the next fifteen years. During that time, mortgage lenders reduced their overhead by outsourcing their processing costs through middlemen, such as settlement agents. Borrowers, nevertheless, paid these costs, whether charged by third parties or by the lender. Many lenders played fast and loose with the TILA rules by not including the fees in the TIL price tag disclosures.<sup>104</sup> They were caught in several lawsuits, one of which resulted in a now-famous court decision. When the Eleventh Circuit released *Rodash v. AIB Mortgage Co.* in 1994, holding that expedited delivery fee and intangible taxes imposed in mortgage loans met the finance charge definition,<sup>105</sup> the mortgage lending industry took exception. Because the inaccurate disclosure of these smaller-sized fees triggered rescission of the loan, congressional leaders took seriously the lending industry’s complaint that the housing finance sky was falling.<sup>106</sup>

On the one hand, Congress excluded not only intangible taxes (the issue in *Rodash*) but also third party closing-agent fees under certain conditions, pest infestation and flood hazard inspection fees, and loan-related document preparation fees from the finance charge definition.<sup>107</sup> On the other hand, Congress beefed up the definition by including mortgage broker fees explicitly.<sup>108</sup> Congress also enlarged and complicated the safe harbor tolerances for errors.<sup>109</sup>

### C. Board Exclusions

The Board began chipping away at the broad statutory definition of the finance charge in the inaugural edition of Regulation Z in 1969. Although the Board added “or as a condition of” to the definitional text,<sup>110</sup> which arguably

103 *Id.* § 613, 94 Stat. at 176-77 (1980), to be codified as 15 U.S.C. § 1637(a).

104 Keest, *supra* note 3, at 363; RENUART & KEEST, *supra* note 19, § 1.2.5.

105 16 F.3d 1142, 1147, 1148 (11th Cir. 1994).

106 See 141 Cong. Rec. S14,566, 14,567 (daily ed. Sept. 28, 1995) (statement of Sen. D’Amato); see also *McKenna v. First Horizon Home Loan Corp.*, 475 F.3d 418, 424 (1st Cir. 2007) (discussing this legislative history); ROHNER & MILLER, *supra* note 88, ¶ 2.01[4].

107 Pub. L. No. 104-29, § 2, 109 Stat. 271 (1995), amending 15 U.S.C. § 1605 (1994).

108 *Id.* Until 1997, the Official Staff Interpretations included broker fees in the finance charge only when the creditor required the use of the broker or retained or split the fee, even though the Act defined a finder fee as a finance charge. Compare 15 U.S.C. § 1605(a)(3), with Truth in Lending (Regulation Z), 60 Fed. Reg. 16,771, 16,777 (Apr. 3, 1995) (codified as amended at 12 C.F.R. pt. 226, supp. I, § 226.4(a) cmt. 3 (1996) (Official Staff Interpretations)).

109 Pub. L. No. 104-29 § 3, 109 Stat. at 272-73, amending 15 U.S.C. § 1605 (1994). For mortgage loans, Congress created a complicated system for determining the finance charge tolerance based upon the type of claim involved and the posture of the legal case. 15 U.S.C. § 1605(f). Congress also shut down any argument that an over-disclosure of the finance charge in a credit transaction secured by real property renders the listed finance charge inaccurate. 15 U.S.C. § 1605(f)(1)(B). These tolerances are discussed more fully in Part XII of this Article.

110 34 Fed. Reg. 2002, 2004 (Feb. 11, 1969). The entire language is as follows:

expanded the scope of the finance charge, the Board excluded many fees from the finance charge that Congress did not. These included late payment, delinquency, default, reinstatement, or similar charges if imposed for actual unanticipated occurrences, and overdraft fees imposed by a bank for paying checks that overdraw the account unless the arrangement was previously agreed to in writing.<sup>111</sup>

At the same time, the Board included assumption fees in the finance charge<sup>112</sup> and acknowledged that the real-estate related fees excluded in section 1605(e) should be finance charges, if inflated or fraudulent.<sup>113</sup>

Since 1969, the Board has revisited Regulation Z's finance charge rules many times. These amendments generally identify additional fees that are either excluded per se or that create conditions that, when met, permit fees to be treated as non-finance charges. For example, in 1981, the Board excluded credit application fees, charges for exceeding a credit limit, and annual or periodic fees to participate in a credit plan.<sup>114</sup> These decisions are difficult to justify because these fees meet the broad statutory definition. Finally, in 1996, the Board excluded debt cancellation fees, using essentially the same conditions for exclusion that apply to credit life insurance premiums.<sup>115</sup>

The excluded fees can contribute mightily, yet invisibly, to the cost of credit. As a result, lenders are motivated to structure their credit transactions to take advantage of these exclusions. One payday lender in Pennsylvania availed

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Except as otherwise provided in this section, the amount of the finance charge in connection with any transaction shall be determined as the sum of all charges, payable directly or indirectly by the customer, and imposed directly or indirectly by the creditor as an incident to or as a condition of the extension of credit, whether paid or payable by the customer, the seller, or any other person on behalf of the customer to the creditor or to a third party . . . .

*Id.* (emphasis added). Whether the "as a condition of" language expands or confuses the finance charge concept is up for debate. See RENUART & KEEST, *supra* note 19, § 3.6.4.

111 34 Fed. Reg. at 2004. For open-end credit, the Board added a requirement that non-finance charges be disclosed in the initial account agreement by identifying those fees and indicating the conditions under which they may be imposed. *Id.* at 2007. As noted above, Congress did not add this distinction to the statute until 1980. See *supra* note 25 and accompanying text.

112 *Id.* at 2004.

113 "Bona fide" should mean legal, actually incurred, and not charged in bad faith or with fraud or deceit. See RENUART & KEEST, *supra* note 19, § 3.9.6.3. "Reasonable" should mean that the fee should be calibrated to comparable charges in the local marketplace and not inflated. *Id.* § 3.9.6.3. The Board's decision to qualify the outright exclusion of these mortgage closing costs was an appropriate attempt to honor TILA's goals. Closing costs for services imposed by the lender and paid by the borrower fit the broad finance charge definition. Nevertheless,

[t]he current rules unfairly favor the mortgage lender [over other types of credit] by permitting it to exclude some of the costs attendant to mortgage credit. Permitting mortgage lenders to pretend that their higher upfront costs are not part of the consumer's price skews the comparison process, unfairly penalizes the non-mortgage lenders, and gives consumers an inaccurate view of how much "cheaper" it is to bet the house.

Keest, *supra* note 3, at 364.

114 46 Fed. Reg. 20,848, 20,894 (Apr. 7, 1981).

115 *Id.* at 20,895.

itself of the Board's generous exclusions for open-end credit and used the annual and periodic fee carve-out to disclose a 400% APR as 6%.<sup>116</sup>

#### D. *Staff Exceptions*

The Official Staff Commentary, first issued after the congressional overhaul of TILA in 1980, continued the Board's approach of carving out specific fees, one by one, from the finance charge.<sup>117</sup>

In the inaugural 1981 edition, the staff interpreted the "comparable cash transaction" exclusion to cover taxes, registration, and license fees paid in both types of transactions. The staff also interpreted the exclusion to cover discounts available to both cash and credit customers, as well as charges for a service policy, auto membership or other policies insuring against latent defects offered or required for both cash and credit customers.<sup>118</sup> In contrast, fees for preparing the TIL disclosure, charges for products required only in a credit transaction, and inspection and handling fees for the disbursement of construction loan proceeds were included in the finance charge.<sup>119</sup>

The original Commentary then described numerous fees that would not be treated as finance charges, though they met the broad statutory definition and were not subject to specific exemptions in the Act. For example, it excluded third party fees for services not required by the creditor, even if the services were required by the third party hired by the lender.<sup>120</sup> A broker fee was not a finance charge when the lender did not require the use of the broker, despite the fact that a "finder" fee or "similar charge" was a finance charge under the Act.<sup>121</sup> Other costs that the staff dubiously labeled non-finance charges

116 See *Pennsylvania Dept. of Banking v. NCAS of Delaware, LLC*, 931 A.2d 771, 779 (Pa. Commw. Ct. 2007) (monthly participation fee of \$149.50 in addition to interest at 5.98%).

117 From 1968 to 1980, the staff "unofficially" responded to inquiries about specific fact situations. During this time, the staff issued more than 1500 separate staff interpretations. See Supplementary Information, *Truth in Lending*, 45 Fed. Reg. 80,648, 80,649 (Dec. 5, 1980). The Board in effect repealed both official and unofficial interpretations and letters when it published the new "Official Staff Interpretations." See Supplementary Information, *Truth in Lending*, 46 Fed. Reg. 50,288, 50,288 (Oct. 9, 1981). Since then, the public opinions of the Staff appear exclusively in the Commentary published in the Federal Register. Consequently, this article will rely only upon the Commentary released since 1981.

118 *Truth in Lending (Regulation Z)* 46 Fed. Reg. 50,288, 50,298 (Oct. 9, 1981). Congress would later carve out discounts for paying by cash or check as opposed to by credit card from the finance charge. 15 U.S.C. § 1666f(b) (2000).

119 *Id.* The Staff also clarified that if a charge in a credit transaction exceeded a charge imposed in a comparable cash transaction, the difference was a finance charge. *Id.*

120 *Id.* Regulation Z in contrast was silent on this issue. 45 Fed. Reg. 80,648, 80,697 (Dec. 5, 1980).

121 Compare 46 Fed. Reg. at 50,298 (Oct. 9, 1981) with 15 U.S.C. § 1605(a)(3) (2000). At least one court implicitly equated a "broker" with a "finder" for purposes of whether the fee charged for that service is a finance charge. *Phillips v. Salem Mortgage Co.*, 24 B.R. 404, 415-416 (Bankr. E.D. Mich. 1982); see also ELIZABETH RENUART & KATHLEEN KEEST, *TRUTH IN LENDING*, §3.7.4.3 (5th ed. 2003) (discussing the equivalence between the role of a broker and a finder).



included: fees for the reinstatement of credit;<sup>122</sup> interest charged on an overdraft account when the bank had not agreed to pay the item in advance;<sup>123</sup> credit report and appraisal fees even if included in an application fee;<sup>124</sup> participation fees even for fixed-term loans;<sup>125</sup> seller's points even if the cost was passed on to the consumer;<sup>126</sup> credit report fees even if it included the cost of verifying the information on the credit report;<sup>127</sup> and notary fees in certain circumstances.<sup>128</sup> The staff generally excluded the creditor's cost of doing business when passed on to the consumer from the finance charge, as long as the cost was not "separately" imposed on the consumer.<sup>129</sup>

The Commentary identified only two types of additional charges as finance charges: charges for certain types of required insurance, such as mortgage guaranty, holder in due course, hospitalization, and repossession insurance<sup>130</sup> and minimum monthly charges or other charges based on current account activity.<sup>131</sup>

Following the 1981 overhaul, the staff amended the Commentary related to the finance charge rules many times: in 1982, 1984, 1985, 1987, 1991, 1995, 1997, and 2003. The changes focused on exceptions to the finance charge. The exclusions outnumbered the inclusions by 14 to 4. Some of the exclusions are difficult to reconcile with the statutory definition. For example, even though Congress explicitly included broker fees in 1995, the staff excluded fees payable to the broker if the fees would be excluded when charged by the creditor.<sup>132</sup> This rule encourages brokers to break out their lump sum fee into categories that allow the components to be excluded, i.e., unbundle their services. The staff also excluded fees to terminate an open-end plan, clearly a fee imposed in connection with the extension of credit.<sup>133</sup>

#### E. *The Case of "Non-Other" Fees*

The Board and staff further whittled away at the vitality of the price tag information by eliminating certain fees from disclosure altogether. As

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122 46 Fed. Reg. at 50,300.

123 *Id.*

124 *Id.*

125 *Id.* However, minimum monthly charges or other charges based on current account activity were not excluded from the finance charge. *Id.*

126 *Id.* It is unclear whether passing on the seller's points in a way other than raising the cash price triggered finance charge status.

127 *Id.*

128 *Id.* at 50,301.

129 *Id.* at 50,298. This language reversed court decisions holding that the amount of the discount at which creditors sell their loans to other parties was a finance charge. *See, e.g., Joseph v. Norman's Health Club, Inc.*, 532 F.2d 86, 93-94 (8th Cir. 1976) (no "separately imposed" standard).

130 46 Fed. Reg. at 50,299.

131 *Id.* at 50,300.

132 Truth in Lending, 62 Fed. Reg. 10,193, 10,194 (Mar. 6, 1997).

133 Truth in Lending, 60 Fed. Reg. 16,771, 16,772 (Apr. 3, 1995).

discussed in Part II, some non-finance charge fees, called “other” fees, must be disclosed at application and on the billing statements, in open-end credit plans. Fees that are neither “other” charges nor finance charges need not be disclosed at all.<sup>134</sup> Whether a fee is an “other” fee or not depends upon whether the charge is “significant” (a limitation not in the Act).<sup>135</sup> The Commentary does not define “significant.”

The 1981 Commentary provided several examples of “other”<sup>136</sup> and “non-other” fees.<sup>137</sup> The Commentary added to these lists over the years, specifically in 1982, 1984, 1987, 1995, 1996, and 2003.<sup>138</sup> Even fees that appear to be within the statutory definition of a finance charge, such as ATM surcharges and fees to terminate a credit card plan, are categorized as “other” charges. As two

134 See Rohner & Durkin, *supra* note 88, at 149 (observing that fees that are not “other” fees “apparently drop off the TILA radar screen”). Compare 46 Fed. Reg. at 50,307 (no discussion of how to notify the consumer about fees that are not “other” charges), with Truth in Lending (Regulation Z), 12 C.F.R. pt. 226, supp. I, § 226.6(b) cmt. 2(vii) (2007) (Official Staff Interpretations) (an ATM fee “imposed . . . by an institution other than the card issuer” need not be separately identified on the periodic statement).

135 46 Fed. Reg. at 50,304.

136 *Id.* at 50,304-05 (including late payment and over-the-credit-limit fees, billing error resolution documents, real-estate related fees, taxes, filing and notary fees, state taxes on the credit transaction, membership or participation fees for services that include an open-end credit feature unless the fees are required whether or not there is a credit feature).

137 *Id.* at 50,305 (including fees charged for documentary evidence of transactions for income tax purposes; amounts payable by a consumer for collection activity after default; attorney’s fees; foreclosure costs; post-judgment interest rates imposed by law; reinstatement or re-issuance fees; premiums for voluntary credit life or disability insurance, or for property insurance, that are not part of the finance charge; application fees; and a monthly service charge for a checking account with overdraft protection that is applied to all checking accounts, whether or not a credit feature is attached).

138 For 1982, charges for submitting as payment a check that was later returned unpaid was *not* an other charge, i.e., not disclosed and not counted. Truth in Lending, 47 Fed. Reg. 41,338, 41,345 (Sept. 20, 1982) (codified as amended at 12 C.F.R. pt. 226, supp. I, § 226.6(b) cmt. 2 (1984) (Official Staff Interpretations)). For 1984, ATM surcharges imposed by a card issuer *were* other charges, i.e., disclosed but not counted in the periodic statement APR; ATM surcharges imposed by a third party *were not* other charges, i.e., not disclosed. Truth in Lending, 49 Fed. Reg. 40,560-61 (Oct. 17, 1984) (codified as amended at 12 C.F.R. pt. 226, supp. I, § 226.6(b) cmts. 1-2 (1985) (Official Staff Interpretations)). For 1987, real estate related fees for services listed in § 226.4(c)(7) *were* other charges, i.e., disclosed but not counted in the periodic statement APR; taxes and filing or notary fees *were not* other charges, i.e., not disclosed. Truth in Lending (Regulation Z), 52 Fed. Reg. 10,875, 10,876 (Apr. 6, 1987) (codified as amended at 12 C.F.R. pt. 226, supp. I, § 226.6(b) cmts. 1-2 (1988) (Official Staff Interpretations)). For 1995, fee to terminate an open-end plan *was* an other charge, i.e., disclosed but not counted in the periodic statement APR. Truth in Lending, 60 Fed. Reg. 16,771, 16,778 (Apr. 3, 1995) (codified as amended at 12 C.F.R. pt. 226, supp. I, § 226.6(b) cmt. 1(vii) (1996) (Official Staff Interpretations)). For 1996, membership or participation fee for a package of services that includes an open-end credit feature, unless the fee is required whether or not the open-end credit feature is included *was* another charge, i.e., disclosed but not counted in the periodic statement APR. Truth in Lending, 61 Fed. Reg. 14,952, 14,955 (Apr. 4, 1996) (codified as amended at 12 C.F.R. pt. 226, supp. I, § 226.6(b) cmt. 1(v) (1997) (Official Staff Interpretations)). For 2003, fees to expedite a payment on a credit or charge account and fees for expediting delivery of a credit or charge card *were not* other charges, i.e., not disclosed and not counted. Truth in Lending, 68 Fed. Reg. 16,185, 16,189 (Apr. 3, 2003) (codified as amended at 12 C.F.R. pt. 226, supp. I, § 226.6(b) cmt. 2(ix) (2004) (Official Staff Interpretations)).

commentators have observed, there is no “principled common denominator” to this non-other category, other than expediency.<sup>139</sup>

A likely result of the staff’s rule is to further encourage creditors to unbundle and mushroom the pricing components of credit and thus keep as many of them off the TIL table as possible. In these circumstances, a “creditor has no incentive to keep its costs down—all it has to do is pretend that it is not part of the cost of production.”<sup>140</sup>

These trends undermine the integrity of the APR and cause consumers to face the complex credit marketplace without accurate and simple price tag information. Dishonest and greedy lenders can and do take advantage of the legal loopholes to the detriment of honest lenders and borrowers alike.

## V. Barriers to Consumer Understanding

Consumers are capable of making credit decisions, provided they are given information in a form that, like the lenders’ ads, plays to their cognitive framework, highlights the key factors, and simplifies the detail. In the following Part, we discuss the importance of an inclusive unitary pricing system given the level of complexity inherent in modern credit transactions, Americans’ financial literacy, and common patterns of consumer decision making.

### A. Literacy

Literacy has three components: prose, document, and quantitative literacy. Prose literacy is the ability to read and write. Document literacy encompasses the capacity to extract and use information from different places in documents and from different documents. Quantitative literacy measures the facility to manipulate and understand information conveyed in numbers, whether unit pricing at the grocery store, preparing a deposit slip, or calculating the interest on a loan.<sup>141</sup> Consumers lack sufficient literacy in all three spheres to face modern credit contracts with any degree of confidence.<sup>142</sup>

Most consumers in the United States, in 1969 as now, can read and write simple sentences.<sup>143</sup> Not surprisingly, credit card issuers compose their solicitation letters in a form that can be read by the majority of the United

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139 Rohner & Durkin, *supra* note 88, at 150 (suggesting that the list probably “represents an ad hoc process of regulatory accretion over time”).

140 Keest, *supra* note 3, at 363.

141 MARK KUTNER, ELIZABETH GREENBERG & JUSTIN BAER, U.S. DEP’T OF EDUC., INST. OF EDUC. SCI., NAT’L CTR FOR EDUC. STATISTICS, A FIRST LOOK AT THE LITERACY OF AMERICA’S ADULTS IN THE 21ST CENTURY 2 (2005), available at <http://nces.ed.gov/NAAL/PDF/2006470.pdf>.

142 See *infra* notes 148-166 and accompanying text.

143 *Id.*

States adult population.<sup>144</sup> However, basic prose literacy is insufficient to extract the necessary pricing information from modern consumer credit contracts.<sup>145</sup> Most credit contracts are written far above basic literacy. Credit card agreements on average require reading at a fifteenth grade level—or three years of college.<sup>146</sup> One agreement reviewed recently by the Government Accounting Office described the interest rates applicable to a credit card at a twenty-seventh grade level—or college plus eleven years.<sup>147</sup>

Even when consumers can read the contracts, consumers cannot locate key information. In a small survey done by the Government Accounting Office (GAO), only one-quarter of the survey respondents could find the default rate in a credit card contract.<sup>148</sup> Most could not locate and were unaware of cross default provisions.<sup>149</sup> Nearly half of the consumers could not determine when a payment would be considered late and none understood the balance computation explanations.<sup>150</sup> In a different survey, respondents could not find the warning that there was no grace period for cash advances or balance transfers, even when prompted.<sup>151</sup> For many key terms in credit contracts,

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144 GAO CREDIT CARD REPORT, *supra* note 13, at 38. The reading level of solicitation letters is, according to the GAO's expert, eighth grade or lower. Only slightly more than half the adult U.S. population can read above an eighth grade level. *Id.*

145 See, e.g., Jinkook Lee & Jeanne M. Hogarth, *Relationships Among Information Search Activities When Shopping for a Credit Card*, 34 J. CONSUMER AFF. 330, 333 (2000) ("[D]ue to the complexity of credit card pricing, consumers still need to spend a great deal of cognitive effort to fully understand the disclosed information."); Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13 STAN. L. & POL'Y REV. 233, 237-38 (2002) (stating that credit documents require the highest levels of literacy. "[Ninety-six percent] of American adults cannot extract and compute credit cost information from contract and disclosure documents.").

146 GAO CREDIT CARD REPORT, *supra* note 13, at 38. Newspaper articles typically have reading levels between ninth and twelfth grade levels. OFFICE OF TECH. ASSESSMENT, ADULT LITERACY AND NEW TECHNOLOGIES: TOOLS FOR A LIFETIME 45 (1993).

147 GAO CREDIT CARD REPORT, *supra* note 13, at 38. At least one issuer exacerbated the readability problems by separating the card member agreement into multiple documents. *Id.* at 41.

148 *Id.* at 49.

149 *Id.* at 49-50. Cross default provisions permit the lender to raise the interest rate if the consumer's credit score falls or the consumer is late or has another default with a different creditor.

150 *Id.* at 50-51. See also MACRO INT'L, INC., *supra* note 27, at 10 (discussing how no respondents in survey group understood what "average daily balance" calculation method was [and] found both the text and mathematics involved too complex"). The interest paid on a credit card is calculated based on what is the account balance, which can fluctuate during the course of the month. This can be the average daily balance or an adjusted balance over one or two months, and it can include or exclude new purchases, among other variables. The higher the balance, the higher the interest, so double cycle billing and balance computation methods that include purchases will usually result in higher interest, at least for typical card users. See Fed. Reserve Board, *Choosing a Credit Card*, <http://www.federalreserve.gov/Pubs/shop/> (last visited Apr. 28, 2008) (explaining that balance computation can make a big difference in the finance charge one will pay); FED. TRADE COMM'N, FTC FACTS FOR CONSUMERS: CHOOSING AND USING CREDIT CARDS 2, 6 (2006), available at <http://www.ftc.gov/bcp/online/pubs/credit/choose.pdf> (explaining balance computation methods and giving a simple example of changes in the finance charge if payments are included or excluded from the balance computation).

151 MACRO INT'L, INC., *supra* note 27, at 31.

consumers look for a number to compare. Without a number, left to a sea of dense text, consumers find the contracts un-navigable.<sup>152</sup>

Identifying and comparing disaggregated fees present special hurdles. When reviewing model disclosure forms with focus groups, half of the respondents in a survey conducted for the Federal Reserve missed at least one fee charged on a sample credit card statement.<sup>153</sup> Only when the researchers grouped and totaled the fees did the borrowers consistently find the fees.<sup>154</sup> Similarly, in a recent survey conducted for the Federal Trade Commission (FTC), consumers reviewing mortgage disclosures were unable to identify or aggregate fees.<sup>155</sup>

Consumers, by and large, lack the quantitative literacy to perform rudimentary calculations related to fees. Most of the U.S. population can compare two stated APRs or finance charges, priced in identical units.<sup>156</sup> When the pricing is not in identical units, however, nearly half of the population cannot make the comparison, even if no computation is required.<sup>157</sup>

When the APR is not fee-inclusive, consumers must compare both an interest rate price and a fee price—a daunting task for many.<sup>158</sup> The FTC

152 *Id.* at 39 (noting that consumers fail to notice penalty rate triggers “because this required a careful reading of text, rather than a simple numerical comparison”); *id.* at 41 (stating that consumers were unable to determine what rate would be charged after the introductory rate expired because the disclosure only indicated that the rate would be equal to “the APR on cash advances,” without providing a numeric percentage figure).

153 *Id.* at 12, 40-41.

154 *Id.* at 41. Respondents who were given “ungrouped” transaction lists consistently had difficulty locating fees. *Id.*

155 FTC DISCLOSURE REP., *supra* note 69, at 32-33 (noting that respondent with a master’s degree, in reviewing fees on GFE, only clearly knew what 5 of 12 identified fees were for; multiple respondents describe the unbundling of fees in the mortgage context as “being nickled and dimed” and thereby concealing the total cost).

156 *See, e.g.,* MARK KUTNER ET AL., LITERACY IN EVERYDAY LIFE: RESULTS FROM THE 2003 NATIONAL ASSESSMENT OF ADULT LITERACY 13 (2007), *available at* <http://nces.ed.gov/Pubs2007/2007480.pdf> (noting that 78% of the U.S. population has basic or better proficiency in quantitative literacy); KUTNER ET AL., *supra* note 141, at 3 (defining basic quantitative literacy as the ability to “locat[e] easily identifiable quantitative information and using it to solve simple, one-step problems when the arithmetic operation is specified or easily inferred,” such that a person with basic quantitative literacy can “compar[e] the ticket price for two events”).

157 On the 1992 National Assessment of Adult Literacy (NAAL), adults were asked to circle which of two brands of peanut butter was more economical. The two brands of peanut butter had both unit pricing and a total price per package. One brand was packaged in 16 ounce containers and unit priced in ounces; the other brand was packaged in 20 ounce containers and unit priced in pounds. No computation was required; respondents only needed to remember that 16 ounces is equal to a pound and compare the unit pricing per pound with the package pricing of a 16 ounce package. Nonetheless, forty-two percent of the adult respondents could not figure out which of two brands was cheaper. U.S. DEPT. OF EDUC., NATIONAL ASSESSMENT OF ADULT LITERACY, at AB40301 (1992), *available at* [http://nces.ed.gov/NAAL/sample\\_items.asp](http://nces.ed.gov/NAAL/sample_items.asp) (select year “1992” and enter text string search “AB40301”). *See also* Eric Nagourney, *Nutritional Information Leaves Many Uninformed*, N.Y. TIMES, Sept. 26, 2006, at F6 (stating that only 60% of consumers can figure out the carbohydrates for half of a bagel given information for the whole bagel).

158 *Cf.* Howell E. Jackson & Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 12 STAN. J.L. BUS. & FIN. 289, 354 (2007) (speculating that the fact that broker compensation is at its highest when brokers are paid both with fees and with an interest rate premium

conducted a survey of homeowners who had taken out mortgages recently and were therefore, presumably, somewhat familiar with mortgage pricing. In a quiet experimental setting, with no time pressure, respondents reviewed disclosures, prepared in accordance with the Board's current finance charge definition.<sup>159</sup> The disclosures were based on two mortgage loans, containing identical interest rates but different closing costs and fees. Thirty-seven percent of the respondents could not identify which loan was cheaper.<sup>160</sup> Aggregating the fees helped 13% of these consumers, but 24% still could not identify the cheaper loan.<sup>161</sup> Generally, only 13% of the adult population has sufficient quantitative literacy to compare the cost of two items when computation is required to arrive at the total cost.<sup>162</sup>

Trying to figure out how fees impact the APR is more complicated than most computations required for comparison shopping. To make this determination, consumers would need, minimally, to understand how interest is calculated (and how to use an amortizing calculator).<sup>163</sup> Yet most adults in the United States do not understand the basic mechanics of interest calculation.<sup>164</sup> For example, the 1992 National Assessment of Adult Literacy (NAAL) asked one question about interest. Survey respondents were asked to find an advertisement for home equity lending in a newspaper (provided to them) and explain how, based on the information in that ad, they could determine the amount that they would pay in interest. The ad stated the monthly payment, the term, the loan principal, and the APR. Respondents did not need to calculate the interest; they only needed to explain how they would calculate the interest. Only 22% of the surveyed adults were able to describe even a simple approach such as subtracting the principal from the total amount paid over the term of the

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and lower when all fees are pushed into the interest rate may be because borrowers can better compare costs when all costs are pushed into the interest rate).

159 FTC DISCLOSURE REP., *supra* note 69, at 41, 122.

160 *Id.* at 85 n.82.

161 *Id.* at 84 n.80.

162 See KUTNER ET AL., *supra* note 141, at 3, 4 (noting that only 13% of the adult population has quantitative proficiency; a "sample task[] typical of level" is "computing and comparing the cost per ounce of food items").

163 The APR calculation is sufficiently complicated that, practically speaking, no one attempts it by hand. Before the advent of amortizing calculators or computer programs, creditors and lawyers consulted prepared tables. These tables merited particular praise from President Lyndon B. Johnson when he signed the bill, given the difficulty and tediousness of the underlying calculations. See Thomas A. Durkin, *Should Consumer Disclosures Be Updated?* 12 n.8 (Joint Ctr. For Housing Studies, Harv. Univ., Paper No. UCC08-10 2008), available at [http://www.jchs.harvard.edu/publications/finance/understanding\\_consumer\\_credit/papers/ucc08-10\\_durkin.pdf](http://www.jchs.harvard.edu/publications/finance/understanding_consumer_credit/papers/ucc08-10_durkin.pdf). For the Federal Reserve's official explanation of how to calculate the APR, see 12 C.F.R. § 226 app. J (2007).

164 See, e.g., MACRO INT'L, INC., *supra* note 27, at 52 ("[V]ery few participants could accurately describe how interest charges were accurately calculated."); cf. Danna Moore, *Survey of Financial Literacy in Washington State: Knowledge, Behavior, Attitudes, and Experiences* (Wash. State Dept. of Fin. Inst. Technical Report No. 03-39, 2003), available at <http://www.dfi.wa.gov/news/finlitsurvey.pdf> (finding approximately 30% of respondents do not understand that if interest compounds, it builds on itself).

loan.<sup>165</sup> If adults are asked to actually calculate compound interest, the results are worse.<sup>166</sup>

Comparing the cost of credit is, of course, more difficult than judging the cost of different containers of peanut butter or cereal. There are far more variables in the pricing of credit than in that of foodstuffs. There are also significant barriers to comparing the cost of credit: we do not purchase our credit at the supermarket, with all of the choices lined up in front of us. Instead, contrasting one credit product with another requires significant expenditure of energy, time, and sometimes money.<sup>167</sup> Often, consumers make decisions about credit under time and emotional pressure.<sup>168</sup> Thus, the national literacy numbers likely reflect a "best case" assessment of our ability to comparison shop for credit.

## B. *Human Blind Spots and Shortcuts*

Most people rely on cognitive shortcuts, or heuristics, to make decisions under time pressure or when confronted with information that is cognitively challenging. This is especially true when consumers evaluate the cost of credit.

Interest is such a sufficiently alien concept to most people that they do not, without prompting, identify it as a cost of credit when shown a credit card statement.<sup>169</sup> People particularly underestimate the effective interest on short-term, small loans. When asked to estimate the payments on a year-long loan, on average, people estimate payments that translate into an effective interest rate

165 The correct answer is that one multiplies the monthly payment by the loan term in months and subtracts the loan principal from the result. Respondents were marked correct for answers as indefinite as saying that you would need to know the total paid over the term of the loan, even if they did not state that they could figure out the total paid by multiplying the term by the monthly payment. U.S. DEPT. OF EDUC., *supra* note 156, at AB50301 (select year "1992" and enter text string search "AB50301") (providing the specific question and more details about the responses).

166 When asked to calculate the compound interest at 10% annually on \$200 over two years, less than 18% of surveyed adults between the ages of 51 and 56 could do so. Annamaria Lusardi & Olivia S. Mitchell, *Baby Boomer Retirement Security: The Roles of Planning, Financial Literacy, and Housing Wealth*, 54 J. MONETARY ECON. 205, 207, 216 (2007); cf. Annamaria Lusardi & Olivia S. Mitchell, *Financial Literacy and Planning: Implications for Retirement Wellbeing* 4, 7, (Pension Research Council, Working Paper No. 1, 2006), available at <http://www.dartmouth.edu/~alusardi/Papers/FinancialLiteracy.pdf> (noting that only 67% of surveyed adults, many over 50, could correctly determine whether, after 5 years of interest at 2% on \$100, they would have less than, more than, or exactly \$102).

167 Peterson, *supra* note 13, at 892-96 (discussing the costs of shopping for various kinds of high-cost credit); see also Patricia A. McCoy, *A Behavioral Analysis of Predatory Lending*, 38 AKRON L. REV. 725, 734-35 (2005) (detailing the difficulties faced by shoppers for subprime mortgage loans).

168 See Sprague v. Household Intern., 473 F. Supp. 2d 966, 972 (W.D. Mo. 2005) (describing closings of real estate loans in less than ten minutes at fast food restaurants and delis); JOHN CASKEY, FRINGE BANKING: CHECK-CASHING OUTLETS, PAWN SHOPS, AND THE POOR 78 (1994) (borrowers from payday lenders are under financial stress and lack alternative sources of credit).

169 See MACRO INT'L, INC., *supra* note 27, at vii (consumers do not identify interest as one of the costs when shown a sample credit card statement).

of 57%.<sup>170</sup> This rate is quite high, much higher than most people pay for credit card interest, for example. When people are then asked to estimate the interest rate on those payments, they uniformly understate the interest.<sup>171</sup> The typical understatement of the APR is a staggering 25 percentage points.<sup>172</sup> This would turn a loan with an effective APR of 35% into one of 10%, for example. Wealth and education reduce, but do not eliminate, the bias.<sup>173</sup> Thus, lenders who disclose only a payment stream can charge consumers more in effective interest than when all the payments are bundled into one, all-inclusive APR.<sup>174</sup>

Many consumers look at the size of the monthly payment in an effort to gauge the interest cost.<sup>175</sup> Like other heuristics, this works relatively well, given the right input: two loans for the same amount, with the same term.<sup>176</sup> In that case, the difference between the two payment streams gives a reasonably accurate measure of the comparative cost. Unfortunately, the reality is far different. Fees may be financed or paid outside the loan; loan amounts may not be comparable; rates can be fixed, variable, or a combination; the loan term can differ; some loans do not fully amortize, causing a balloon payment; monthly payments can vary. A cash advance on a credit card may be repayable over a period of years, while the same cash advance from a payday lender is repayable in two weeks. Using the monthly payment as a gauge for the comparative cost of two loans breaks down in the face of the complexity of modern lending.<sup>177</sup>

170 Stango & Zinman, *supra* note 28, at 5, 38. The median is 43%; the 25th percentile is 35% and the 75th percentile is 81%.

171 *Id.* (asserting that 98% of respondents underestimated the APR given a payment stream and total number of payments). These results were based on an analysis of two questions on the 1983 Survey of Consumer Finances. The questions asked respondents to estimate how much they would have paid after a year if they financed a \$1000 purchase and then what the interest rate they would have paid would be. An alternate interpretation of the results could be that consumers work backwards from known interest rates and overestimate the payments on a given interest rate. This seems unlikely, however, as the consumers who most underestimated the implied interest rate were most likely to be paying high rates on their existing loans and to be borrowing more extensively from finance companies than banks. *Id.* at 12-13; see also Oren Bar-Gill, *Bundling and Consumer Misperception*, 73 U. CHI. L. REV. 33, 45 (2006) ("Many consumers systematically underestimate the total price they will end up paying simply because they do not understand how fast interest accrues.").

172 The median underestimation is 25 percentage points; the mean is 38 percentage points. Stango & Zinman, *supra* note 28, at 5-6.

173 *Id.* at 12.

174 See *id.* (claiming that consumers pay more in interest in markets where the APR is not uniformly disclosed). This tendency to underestimate the effective interest rate created by a stream of payments may explain some of the consumer tolerance of high rates in payday lending, auto title loans, and bounce loans, for example, as well as high late fees and over the limit fees in credit card lending.

175 Consumers also do this as a rational way of assessing the impact of the payments on their monthly budget. See, e.g., Willis, *supra* note 69, at 788-89 (discussing borrower reliance on the monthly payment in the home mortgage context).

176 See REN S. ESSENE & WILLIAM APGAR, JOINT CTR. FOR HOUSING STUDIES, HARVARD UNIV., UNDERSTANDING MORTGAGE MARKET BEHAVIOR: CREATING GOOD MORTGAGE OPTIONS FOR ALL AMERICANS 20 (2007) ("If the loan terms being compared were held constant, this would be equivalent to finding the loan with the lowest interest rate.").

177 See APGAR & HERBERT, *supra* note 30, at I-16 (2006).



Part of the trouble understanding interest arises because it involves deferred payments. Most people are irrationally optimistic in future planning.<sup>178</sup> Consumers underestimate their use of credit<sup>179</sup> or how often they will pay late, run over limit, or otherwise incur fees on their credit.<sup>180</sup> Most people are inclined to believe both that they will have more money and will be more frugal in the future.<sup>181</sup> Consumers can and do err in the opposite direction: they can fail to borrow enough or overestimate how much credit they will need. Such mistakes, however, tend to be less costly than those of underestimation of credit use.<sup>182</sup>

The overconfidence bias, coupled with lack of understanding of interest, contributes to overspending when consumers purchase on credit.<sup>183</sup> Future

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178 For a discussion of the overconfidence bias in the context of consumer credit, see Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1375-76 (2004), and Jason J. Kilborn, *Behavioral Economics, Overindebtedness & Comparative Consumer Bankruptcy: Searching for Causes and Evaluating Solutions*, 22 EMORY BANKR. DEV. J. 13, 18-19 (2005). This propensity toward optimism is not limited to consumers. For example, at President Herbert Hoover's inaugural address on March 4, 1929, seven months before the stock market crash, he proclaimed: "I have no fears for the future of our country. It is bright with hope." WEBSTER'S QUOTATIONARY 514 (Leonard Roy Frank ed., 2001). Another example would be the Federal Reserve Board's assurance that mortgage lenders were appropriately managing the risks associated with subprime lending up until the rapid decline in the housing market in 2007. See, e.g., Alan Greenspan, Chairman, Fed. Reserve Bd. of Governors, Remarks at the Credit Union National Association 2004 Governmental Affairs Conference: Understanding Household Debt Obligations (Feb. 23, 2004) ("The ability of lending institutions to manage the risks associated with mortgages that have high loan-to-value ratios seems to have improved markedly over the past decade . . ."). Consumers (and others) may well have reason to believe that they will perform better in the future than they have in the past; such a belief is not by itself irrational. See, e.g., Leda Cosmides & John Tooby, *Are Humans Good Intuitive Statisticians After All? Rethinking Some Conclusions from the Literature on Judgment Under Uncertainty*, 58 COGNITION 1, 10-20 (1996) (discussing data that show that individuals' overconfidence in areas of special knowledge is sometimes justified). Indeed, it may be highly adaptive. Colin Camerer & Dan Lovallo, *Overconfidence and Excess Entry. An Experimental Approach*, 89 AM. ECON. REV. 306, 306 n.1 (1999). Nonetheless, the failure of consumers to allow for the possibility that they might be acting irrationally can and does get them into trouble.

179 E.g., Lee & Hogarth, *supra* note 145, at 333.

180 See Bar-Gill, *supra* note 171, at 49 (listing various ways in which consumers underestimate use of credit cards and expenses associated with them); cf. *Credit Card Hearings*, *supra* note 62, at 71-73 (testimony of Alys Cohen) (consumers do not shop on the penalty rate or late fee, even though many will incur both).

181 Cf. Robert L. Clark & Madeleine B. d'Ambrosio, *Ignorance is Not Bliss: The Importance of Financial Education*, RESEARCH DIALOGUE 1, 10 (Dec. 2003), available at <http://www.tiaa-crefinstitute.org/research/dialogue/docs/78.pdf> (discussing that a financial education seminar was successful in changing retirement goals, but only 25-40% of respondents, university employees, had increased savings three months after the seminar).

182 See Agarwal, et al., *supra* note 61, at 16. A majority of borrowers in this credit card study overestimated their borrowing and paid more for an annual fee than they would have incurred in interest costs. Significantly, however, the borrowers who overestimated their borrowing made a relatively small and bounded mistake; their losses were no greater than the amount of the annual fee. The overconfident borrowers in the study, who did not pay the fee, thinking they would be revolvers and not chargers, incurred much larger—and unbounded—interest costs from their error.

183 In one study, borrowers were willing to pay twice as much for tickets when purchasing them with credit cards instead of cash. HASTIE & DAWES, *supra* note 20, at 223, (citing Drazen Prelec & Duncan Simester, *Always Leave Home Without It*, unpublished manuscript (1998), later published as Drazen Prelec & Duncan Simester, *Always Leave Home Without It: A Further Investigation of the*

payments seem small.<sup>184</sup> A comprehensive APR combats this blind spot because it reminds consumers of the true, comparable cost of credit precisely at the times and places when they are most prone to ignore more complex price-tag information.<sup>185</sup> Consumers are most prone to make costly errors and to tolerate a high APR when entering an apparent short-term, small dollar transaction.<sup>186</sup> The discipline of an APR is essential, particularly in this circumstance since many short-term loans become expensive long-term debt service.<sup>187</sup>

The cognitive usefulness of the APR also is important in helping consumers to aggregate fees. Borrowers easily can be misled as to the cost of any particular fee depending on the category the fee is assigned to, whether it is from present or future consumption, and whether it is, compared to the overall transaction, a large sum or small sum.<sup>188</sup> Consumers account for the same dollar differently depending on its intended use.<sup>189</sup> On individual purchases, how much consumers are willing to spend—or how eager they are to save—is roughly proportional to the total cost they anticipate incurring. Most of us

*Credit-Card Effect on Willingness to Pay*, 12 MARKETING LETTERS 5 (2000)); see also Bar-Gill, *supra* note 171, at 49-50 (discussing how bundling contributes to consumers' overconsumption of credit).

184 Partly this is connected to risk aversion: a future adjustment in payments that is uncertain and speculative may appear to be an acceptable risk to avoid a certain loss now in the form of a higher "downpayment or initial monthly mortgage payment." ESSENE & APGAR, *supra* note 176, at 20.

185 See Stango & Zinman, *supra* note 28, at 4 (noting that in markets where the APR is routinely disclosed, i.e., regulated bank lending, the disclosure of APR is correlated with lower interest rates for consumers with most pronounced difficulty projecting interest costs).

186 See Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1121-22 (2000) (stating that discount rates are steepest for short term loans and decline the longer a loan is expected to last); George Loewenstein & Richard H. Thaler, *Anomalies: Intertemporal Choice*, 3 J. ECON. PERSP. 181, 183-87 (1989) (collecting and discussing studies that show higher discount rates for short-term and small loans than longer, larger loans).

187 See, e.g., DEMOS & CTR. FOR RESPONSIBLE LENDING, *THE PLASTIC SAFETY NET: THE REALITY BEHIND DEBT IN AMERICA: FINDINGS FROM A NATIONAL HOUSEHOLD SURVEY OF CREDIT CARD DEBT AMONG LOW- AND MIDDLE-INCOME HOUSEHOLDS* 6 (2005), available at [http://www.demos.org/pubs/PSN\\_low.pdf](http://www.demos.org/pubs/PSN_low.pdf) (finding that nearly a third of low- and middle-income households have credit card debt for three months or more, and that among those with credit card debt, the median length of time they had been in debt was 30 months); Michael A. Stegman & Robert Farris, *Payday Lending: A Business Model that Encourages Chronic Borrowing*, 17 ECON. DEV. Q. 8, 20-21 (2003) (collecting statistics on the frequency of rollover of payday loans, suggesting that a majority of all payday borrowers are repeat customers).

188 See generally HASTIE & DAWES, *supra* note 20, at 222-24 (discussing various forms of mental accounting).

189 In one experiment, subjects were asked first whether they would buy a \$10 theater ticket if they lost a ten-dollar bill while on their way to purchase the ticket. Most subjects said yes. Then they were asked whether they would purchase a replacement ticket, if they lost the first. Most said no. In either case, the subjects first lost \$10. In one case, they lost \$10 of general revenue, which did not prevent them from spending an additional \$10 on entertainment. In the second case, having lost \$10 committed to entertainment, the subjects were disinclined to replace it. Consumers were willing to spend \$20 if the fees were disaggregated and \$10 was credited to "general revenue" and \$10 to "entertainment," but only \$10 if "entertainment" were charged the entire cost. Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCIENCE 453, 457 (1981).

evaluate our gains and losses with reference to our initial starting point.<sup>190</sup> A gain or loss that is small in relation to our reference point is apt to be disregarded. Thus, the same \$10 is treated as consequential in a purchase of \$50 worth of groceries, but inconsequential in the purchase of a \$500 computer.<sup>191</sup>

By unbundling fees, lenders hide the magnitude of the cost of credit from consumers in at least two ways. First, depending on how the fees are characterized, consumers may intuitively place them in different categories of their mental budget—insurance and interest, perhaps, or an expedited payment convenience fee versus an annual fee. Consumers are willing to pay twice out of two separate budget items, but less happy about paying twice out of the same budget line item. Second, the fees may look small compared to the total transaction and thus are more palatable. Unbundled fees, in addition to challenging quantitative literacy skills, can evade cognitive notice altogether.<sup>192</sup> Consumers do not perceive the total cost if they allocate the fees to different pots.

The problems understanding interest and aggregating fees compound when consumers try to think about both factors at once. Consumers who try to combine two or more price components in home mortgage shopping pay more for their mortgages than consumers who are shopping on a single price component.<sup>193</sup> Consumers in general have trouble weighing the combined effect of multiple choices, tending instead to consider each decision independently.<sup>194</sup> Despite the literally hundreds of credit cards to choose from, most consumers will compare no more than seven cards in choosing a credit card.<sup>195</sup> On average, they will look at less than two sources of information when deciding which credit card to choose.<sup>196</sup> In reading monthly statements,

190 Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision under Risk*, 47 *ECONOMETRICA* 263, 277 (1979).

191 Tversky & Kahneman, *supra* note 189, at 457 (observing that “[m]any readers will recognize the temporary devaluation of money which facilitates extra spending and reduces the significance of small discounts in the context of a large expenditure, such as buying a house or a car”). See, e.g., FTC DISCLOSURE RPT., *supra* note 69, at 32 (“This Tax Related Service Fee didn’t make any sense to me. It was \$75 so I overlooked it for the convenience of signing papers there.”).

192 See MACRO INT’L, INC., *supra* note 27, at vii (stating that consumers do not notice the cumulative effect of paying small amounts of fees every month); Richard H. Thaler, *Mental Accounting Matters*, 12 *J. BEHAVIORAL DECISION MAKING* 183, 194 (1999) (finding that small disaggregated fees are ignored).

193 SUSAN WOODWARD, CONSUMER CONFUSION IN THE MORTGAGE MARKET 2 (2003), available at [http://www.sandhillecon.com/pdf/consumer\\_confusion.pdf](http://www.sandhillecon.com/pdf/consumer_confusion.pdf).

194 Daniel Kahneman & Dan Lovallo, *Timid Choices and Bold Forecasts: A Cognitive Perspective on Risk Taking*, 39 *MGMT. SCI.* 17, 19-20 (1993); Tversky & Kahneman, *supra* note 189, at 455; see also MACRO INT’L, INC., *supra* note 27, at vii (consumers overlook the cumulative effect of paying a small amount of interest and fees on a credit card loan).

195 See Lee & Hogarth, *supra* note 145, at 341 (20% of consumers looked only at one card and, on the other side of the scale, only 8.1% looked at eight or more; the mean number of compared cards was 5.29; the median was 4).

196 *Id.* at 340.

consumers pay attention to only a few categories of information, typically no more than three.<sup>197</sup>

Recall that the FTC study on mortgage disclosures revealed that 24% of respondents could not pick the cheaper loan even after they reviewed improved disclosures that aggregated fees. Contrast this result to an earlier FTC study in which only 10% of respondents could not pick the cheaper loan.<sup>198</sup> Why the difference? The authors opined that the simpler disclosure used in the earlier study accounted for the result. Adding a single additional cost disclosure—one fee plus some explanatory text—to the previously tested disclosures caused the rate of correct identification of the cheaper loan to drop from 94% to 65%.<sup>199</sup>

Individual consumers operate in a fuzzy world, governed at least in part by non-economic and intangible rewards and objectives.<sup>200</sup> Often, lenders, acting in their rational self-interest, frame the credit purchasing decision to exploit consumers' thinking, whether by increasing complexity or encouraging risky behavior.<sup>201</sup> Consumers need an objective, external trigger to focus their analytical thinking when they shop for credit.<sup>202</sup>

197 MACRO INT'L, INC., *supra* note 27, at 19 (reporting information about three categories: payments, the account activity summary, and the transaction list, and disregarding most other information was disregarded). Some evidence suggested that even the account activity summary was largely disregarded in favor of the transaction list. *Id.* at 31.

198 JAMES M. LACKO & JANIS K. PAPPALARDO, FED. TRADE COMM'N, THE EFFECT OF MORTGAGE BROKER COMPENSATION DISCLOSURES ON CONSUMERS AND COMPETITION: A CONTROLLED EXPERIMENT 24 (2004), available at <http://www.ftc.gov/os/2004/01/030123mortgagefullrpt.pdf> [hereinafter FTC MORTGAGE BROKER COMPENSATION RPT] ("approximately 90% of the respondents in the two control groups correctly identified the less expensive loan"); see also FTC DISCLOSURE RPT., *supra* note 69, 83 n.78 (stating that the disclosure form tested in the earlier study was only half a page long, had only nine cost disclosures, and highlighted the cost disclosure (mortgage broker compensation) that varied between the two forms.) Although the earlier study did not provide an APR, it did aggregate fees. In contrast, the forms tested in the more recent study were more than a page, contained several dozen cost disclosures, and highlighted multiple key terms. FTC MORTGAGE BROKER COMPENSATION RPT, *supra* note 97, at G-3 to -14, H-1 to -25.

199 See FTC MORTGAGE BROKER COMPENSATION REPORT, *supra* note 198, at 28; FTC DISCLOSURE RPT., *supra* note 69, at 84 n.79.

200 See Korobkin & Ulen, *supra* note 185, at 1103 ("[A] large number of external circumstances can affect the utility he will receive from each option."). "Fuzzy" thinking is used to describe a mode of thinking that evaluates ambiguous and uncertain situations in a holistic and fluid manner, without reference to precise probabilities. See, e.g., Lofti A. Zadeh, *Discussion: Probability Theory and Fuzzy Logic Are Complementary Rather Than Competitive*, 37 TECHNOMETRICS 271 (1995).

201 See, e.g., *Ting v. AT&T*, 182 F. Supp. 2d 902 (N.D. Cal. 2002) (arbitration staffer was designed by AT&T so as not to be read by consumers); ESSENE & APGAR, *supra* note 176, at 25 (mortgage marketers use payment heuristic to steer consumers to expensive loans); Bar-Gill, *supra* note 178 (credit card pricing is based on consumers' underestimation of future spending); Richard H. Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAVIOR & ORG. 39, 45 (arguing that card issuers lobbied against credit card surcharges while supporting discounts for cash because they understood that card users would be reluctant to pay a surcharge but would be willing to forgo a discount).

202 Cf. Kurt Eggert, *Truth in Gaming: Toward Consumer Protection in the Gaming Industry*, 63 MD. L. REV. 217 (2004) (arguing that the adoption of simple, individually tailored disclosures in the gambling industry would assist even problem gamblers in assessing the costs of gambling and making rational choices).

Many commentators, including the Federal Reserve Board, have stressed the importance of increased literacy as an antidote to high-priced credit.<sup>203</sup> Literacy is an inadequate solution for the arms race between consumers and lenders. Today's literacy programs explain yesterday's products. Lenders constantly ratchet up the level of complexity of the products sold. Lenders also study and exploit consumers' natural biases.<sup>204</sup> As the Chairman of the Federal Reserve Board has recognized, consumers need more than literacy: among other matters, they need clear and uniform disclosures.<sup>205</sup>

When enacting TILA, Congress did not aim for complete consumer understanding. Its goal was not complete financial literacy or sophisticated understanding of pricing mechanisms. Instead, Congress recognized that credit information presented in simple, uniform terms would best arm consumers to avoid expensive credit and inflated debt loads.

## VI. The Goal: Meaningful and Simple Disclosure

Given what we know about consumers' limited capacity to process complicated information, disclosures must be both simple and comprehensive. Disclosures will not be effective if they require intermediate computational steps, such as the summation of various fees. Consumers cannot generally calculate interest or evaluate the tradeoff between a higher interest rate and lower fees on their own, especially where there are multiple fees in different amounts assessed for different reasons.<sup>206</sup>

Congress designed the APR to be *the* single number that consumers should focus upon when shopping for credit.<sup>207</sup> Despite its limitations, the APR

203 See, e.g., Sandra Braunstein & Carolyn Welch, *Financial Literacy: An Overview of Practice, Research, and Policy*, FED. RES. BULL. 445, 449 (Nov. 2002), available at <http://federalreserve.gov/pubs/bulletin/2002/1102lead.pdf> (discussing the role of the Federal Reserve System in promoting financial literacy); Alan Greenspan, Chairman, Bd. of Governors, Fed. Reserve Sys., Remarks on Financial Education at JumpStart Coalition's Annual Meeting (Apr. 3, 2003), available at <http://www.jumpstartcoalition.org/fileuptemp/GreenspanRemarks.htm> (discussing importance of financial education in "empowering" consumers). For a thoughtful critique of financial literacy as a replacement for regulation and particularly the language of consumer "empowerment," see Toni Williams, *Empowerment of Whom and for What?: Financial Literacy Education and the New Regulation of Consumer Financial Services*, 29 LAW & POL'Y 226 (2007).

204 Cf. Max H. Bazerman, *Consumer Research for Consumers*, 27 J. CONSUMER RES. 499, 502 (2001) (discussing systematic marketing to consumers' biases in the sale of mutual funds).

205 *Improving Financial Literacy in the United States. Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 9-10 (2006) (statement of Ben S. Bernanke, Chairman, Bd. of Governors, Fed. Reserve Sys.).

206 Cf. Agarwal, et al., *supra* note 61 (reporting that under ideal conditions, when borrowers were choosing between a card with no annual fee but high APR and a card with an annual fee and low APR, 40% of borrowers chose the wrong contract).

207 Jinkook Lee & Jeanne M. Hogarth, *The Price of Money: Consumers' Understanding of APRs and Contract Interest Rates*, 18 J. PUB. POL'Y & MARKETING 66, 66 (1999) ("The APR was introduced as a summary measure of the price of a loan to make consumers' comparison shopping easier . . .").

has become the bedrock piece of information consumers consider.<sup>208</sup> In 2000, 91% of the population was “aware” of the APR.<sup>209</sup> More than 70% of the population reports using the APR to shop for closed-end credit.<sup>210</sup> 76% of credit card holders in 2001 regarded the APR as a “very important” credit term,<sup>211</sup> suggesting that they too used it to shop for credit.

In a survey of Washington state residents, 82 % of all respondents said that the APR was the “most important thing to look at when comparing credit card offers.”<sup>212</sup> 78% of homeowners who refinanced their homes report comparison shopping on the basis of the APR.<sup>213</sup> These numbers far exceed the percentages of the population that can describe how to calculate interest or the APR.<sup>214</sup>

The success of the APR may be due to its prominent disclosure. In the credit card context, key disclosures are segregated in what is called the “Schumer box.” Closed-end disclosures contain a similar “federal box,” across the top, which contains four key disclosures: the APR, the finance charge, the amount financed, and the total of payments. Evidence indicates that both the Schumer box disclosures and the federal box are accessible and intelligible.<sup>215</sup>

The APR’s success as a shopping tool also may be due to consumers’ faith—granted without understanding—that the APR does what TILA’s creators hoped for: provides a comparable number for shopping. Consumers do not need to understand the APR to use it; they need only be aware of it.<sup>216</sup>

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208 See Jeff Sovern, *Toward a Theory of Warranties in Sales of New Homes: Housing the Implied Warranty Advocates, Law and Economics Mavens, and Consumer Psychologists under One Roof*, 1993 WIS. L. REV. 13, 39 n.110 (collecting articles discussing increase in consumer awareness and use of APR).

209 Durkin, *supra* note 49, at 631.

210 Lee & Hogarth, *supra* note 207, at 74.

211 Durkin, *supra* note 26, at 203; see also Lee & Hogarth, *supra* note 145, at 341 (mentioning that in a 1997 consumer survey, 68.1% of consumers reported using the APR to shop for credit cards, more than used any other cost feature for shopping).

212 MOORE, *supra* note 164, at 27.

213 Jinkook Lee & Jean M. Hogarth, *Consumer Information Search for Home Mortgages: Who, What, How Much, and What Else?*, 9 FIN. SERVICES REV. 277, 286 (2000).

214 Most adults do not understand how the APR is calculated. FTC DISCLOSURE RPT., *supra* note 69, at 98; Lee & Hogarth, *supra* note 207, at 67, 74.

215 GAO CREDIT CARD REPORT, *supra* note 13, at 17, 39 (the Schumer box simplifies presentation of key terms and increases consumer awareness); Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13 STAN. L. & POL’Y REV. 233, 238 (2002) (reporting that the federal box, by itself, has “very low complexity” and is “usable by virtually any reader”); Sovern, *supra* note 208, at 72 nn.230-35 (stating that the federal box is a model of consumer disclosure); see also MACRO INT’L, *supra* note 27, at 26 (stating that consumers look for the Schumer box and indicate that it is the most important part of a credit offer).

216 In the 1967 TILA hearings, Lenor Sullivan, then the Chair of the House Subcommittee on Consumer Affairs, made it a point to explain that the goal of TILA was awareness, not understanding. *House Hearings*, *supra* note 5, at 243.

Some scholars have questioned the APR's utility.<sup>217</sup> Sometimes the APR is confused with the interest rate.<sup>218</sup> Others criticize the APR because it is expressed as a percentage, noting that people have a greater intuitive understanding of whole numbers than percentages.<sup>219</sup> Whether this consumer preference interferes with consumers' ability to comparison shop between two numbers, both stated in percentages, is dubious. Consumers do not necessarily freeze when they see the percentage symbol, "%." Instead, they have difficulty performing mathematical operations on percentages, particularly probabilistic calculations.<sup>220</sup>

Some commentators, particularly within the industry, criticize the APR provided with billing statements in open-end credit as confusing and not useful to consumers.<sup>221</sup> In part, this last weakness is the Board's fault. The Board has not attempted to make the periodic APR clear and useful to consumers, either by improved labeling and explanation or by requiring a typical APR prior to the extension of credit. Such changes would enable consumers to use the periodic APR effectively.<sup>222</sup>

The entire TIL disclosure regime admittedly does not permit perfect comparison shopping. The TIL information related to variable rate loans is particularly useless.<sup>223</sup> Even if the finance charge included all fees, the APR

217 See, e.g., Edwards, *supra* note 8, at 223-26 (discussing criticisms of the APR as simplifying the decision too much, failing to include all relevant fees, and coming too late in the process); Peterson, *supra* note 13, at 898-99 (APR is not all inclusive and comes too late in the process); Willis, *supra* note 69, at 822 ("The APR is a failed instrument of social policy.").

218 See, e.g., MACRO INT'L, INC., *supra* note 27, at 47. This is only a problem if you think that individual consumers should be separately evaluating all the price components of credit: the rate, the fees, the payment allocation method, the grace period, the billing cycle, the penalty rate, the cash advance rate, the minimum payment formula, etc. If you think, as we do, and as the drafters of TILA did, that consumers should use the APR instead of the interest rate, then consumers' "confusion" is in fact a sign of the APR's success and explanatory power.

219 Willis, *supra* note 69, at 781-82; Lee & Hogarth, *supra* note 207, at 67 (citing Jean Kinsey & Ray McAlister, *Consumer Knowledge of the Costs of Open-End Credit*, 15 J. CONSUMER AFF. 249 (1981); and Rob Raynard & Gill Craig, *Estimating the Duration of a Flexible Loan: The Effect of Supplemental Information*, 14 J. ECON. PSYCHOL. 317 (1993)).

220 Cosmides & Tooby, *supra* note 178, at 18; Justin Kruger & Patrick Vargas, *Consumer Confusion of Percent Differences*, J. CONSUMER PSYCHOL. (unpublished manuscript, available at <http://ssrn.com/abstract=946238>).

221 See, e.g., Truth in Lending, 72 Fed. Reg. 32,948, 32,996-97 (June 14, 2007) (cataloguing industry complaints). Another concern is how the billing statement APR is calculated since it may not be consistent from one month to the next, depending on the balance at the beginning of the cycle or the amount and timing of each payment during the cycle. *Id.* However, whatever idiosyncrasies there might be, the bottom line is consistency. If the APR is calculated the same way by all lenders, then it is meaningful as a measure of the costs.

222 See, e.g., MACRO INT'L, INC., *supra* note 27, at 47 (re-labeling the periodic APR the "Fee-Inclusive APR" increased both understanding of the periodic APR and appreciation of its utility).

223 The TIL disclosure form only advises the borrower that the loan has a variable rate; it does not tell the borrower what the maximum payment or maximum interest rate will be or even how the rate will change. 15 U.S.C. § 1637(c)(1)(A) (2000) (open end credit); 15 U.S.C. § 1638(a)(14) (closed end home purchase). *But see* 15 U.S.C. § 1637a(a)(2) (open end credit secured by a home) (requiring disclosure of how the rate will change; but not requiring disclosure of the maximum payment). The variable rate disclosures specific to that loan—of how the rate will be calculated, of the index used, and, for home mortgages, the maximum interest rate—that are made can be scattered through the loan

would still fail to account for all economic costs that arise after a loan's inception in closed-end transactions.<sup>224</sup> The APR does not and cannot consider the issue of whether the credit is a good fit (suitable) for the consumer's needs and circumstances. Nor can it address the subjective reasons a consumer might prefer one source or type of credit over another.

Moreover, TILA does not require disclosure of a fee-inclusive APR before the credit is extended. This is a serious hindrance to shopping for either open-end or closed-end credit. In closed-end loans, lenders need only provide the fee-inclusive APR at closing.<sup>225</sup> In the context of open-end lending, consumers also do not receive a comprehensive APR before acceptance of the credit card plan or home equity loan.<sup>226</sup> Instead, consumers are provided only with the interest rate and a list of fees in advertisements, solicitations, and contracts.<sup>227</sup>

Despite these limitations in the Act, the APR allows consumers to navigate the otherwise impenetrable world of credit pricing. It simplifies a complex calculation. It is, like other heuristics, a "rule of thumb" that allows consumers to find an acceptable solution to an overly complex problem.<sup>228</sup>

documents. See McCoy, *supra* note 63, at 153-54 (discussing needed improvements to the current variable rate disclosures in the mortgage context); see generally RENUART & KEEST, *supra* note 19, §§ 4.8 (TIL variable rate closed end disclosures), 5.5.10 (TIL variable rate open end disclosures). Professor McCoy does not address the problem of how to calculate the APR in a variable rate loan, an issue that is separate and distinct from the question we raise in this article—the issue of a fee-inclusive APR. Currently, the APR on a variable rate loan is calculated and disclosed assuming no change in the underlying index. Truth in Lending (Regulation Z), 12 C.F.R. pt. 226, supp. 1, § 226.17(c)(1) cmts. 8 & 10 (2007) (Official Staff Interpretations) (without and with the effect of a teaser rate, respectively). The use of this unrealistic assumption paints an overly rosy picture of the true cost when rates rise, especially where the initial or fully indexed rate is the rate floor.

224 Examples of post-inception costs include: prepayment penalties, late and over-limit fees, the increase in the rate when the rate can adjust, and the actual versus assumed duration of the loan. This last problem, one of duration, receives much attention in the context of mortgage lending. See *supra* note 20.

225 The statute requires that the disclosures be provided before the borrower is contractually obligated. 15 U.S.C. §§ 1638(a)(4), (b)(1) (2000). In practice, this may mean that the borrower is asked to initial the TIL disclosure form seconds before signing the loan contract. In the case of a home purchase, lenders must give good faith estimates of the APR within three days of the borrower's application. 15 U.S.C. § 1638(b)(2). This disclosure is not binding; if the information later changes, the lender need simply give the borrower a new disclosure at closing. *Id.*

226 One of TILA's greatest anomalies is the difference between the APR in open-end home secured loans (merely the periodic interest rate), 15 U.S.C. § 1640(a)(1) (2000), versus that in closed-end home secured loans (the more fully loaded APR), 15 U.S.C. § 1640(a)(2). Consumers thus cannot rely on the APR to compare a subordinate lien home improvement loan from two different lenders when one is open-end and the other is closed-end based.

227 After the consumer has used the credit, TILA requires a disclosure of a more meaningful APR, reflecting some of the fees incurred for that billing cycle. This post hoc disclosure can waken consumers to their actual as opposed to idealized spending patterns and make changes accordingly. See text accompanying notes 24-25, *supra*.

228 Herbert Simon's groundbreaking work in economics explored the problem of how individuals and organizations make decisions with limited time and information. He described the process of choosing a "good enough" solution as "satisficing." Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 Q.J. ECON. 99, 118 (1955); Herbert A. Simon, *Rationality as Process and as Product of Thought*, 68 AM. ECON. REV. 1, 10 (1978).



Without understanding the minutiae of the APR, it is possible for consumers to use it to shop.

The progenitors of TILA recognized that most Americans cannot, and never will, understand credit pricing's intricacies. Current research confirms this prediction. The APR's purpose is to allow consumers to shop intelligently and efficiently without understanding these complexities. The APR need not be precisely correct as an economic measure of the cost of credit. Not every nuance of future value or interest rate fluctuation need be accounted for. Consumers can profitably use the APR, provided that it is a comprehensive and comparable measure of the cost of credit.

The question policymakers must ask is: how do we make the APR meaningful and comprehensive? The law must assure that the APR and the finance charge provide "apples-to-apples" comparisons. Charges must be consistently included or excluded; lines must be clear, to ease compliance and diminish subterfuge; and the presumption must be in favor of inclusion. The resulting transparency promotes the price competition envisioned by Congress in 1968. When the APR is inclusive, consumers can shop wisely and well.<sup>229</sup>

Absent mandatory, comprehensive, and simple pricing disclosures, lenders have perverse incentives to create complicated pricing structures, including different rates on different balances, multitudinous fees, variable rates, and payment options. These products, by their design, obscure the true price of credit. Unsurprisingly, lenders have responded to the current regulatory environment by evolving ever more complex and profitable products. In order for consumers to shop wisely and well, the finance charge definition must be revitalized. In the next Parts, we return to the finance charge definition, parse its meaning, and suggest a short-form test that achieves the goal of an effective APR.

## VII. The Finance Charge Definition Revisited: Why It Most Accurately Reflects the True Cost of Credit

The Act itself offers bright lines for creditors, consumers, and enforcement agencies in assessing how all fees ought to be disclosed and whether they should be included in the calculation of the APR. The statutory definition has three distinct components: payable directly or indirectly by the consumer; imposed directly or indirectly by the creditor; and incident to the extension of credit.

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229 As Herbert Simon points out, the easier it is to discover a satisfactory solution, the higher the standard for an acceptable solution becomes. *Id.* at 111.

A. *"Payable Directly or Indirectly by the Consumer"*

This first prong recognizes that what is crucial is not *how* the fee is presented to the consumer, but that the consumer ultimately *pays* the fee, regardless of format or characterization.<sup>230</sup> For example, some car dealers increase the cash price to cover the discount the dealer pays when it later sells the loan.<sup>231</sup> The directly/indirectly language prevents creditors from circumventing a comprehensive finance charge and a meaningful APR.

B. *"Imposed Directly or Indirectly by the Creditor"*

The second component pulls a wide variety of charges into the finance charge. By adding the phrase "directly or indirectly," Congress underscored that this element is expansive rather than restrictive. Regardless of how a creditor unbundles the costs and who performs the activities that generate the fees, if the consumer pays them, directly or indirectly, they are finance charges. "Optional" fees may be covered unless they are charged to consumers in both cash and credit transactions.

This reading of the statutory language is buttressed by Congress' use of the word "impose." "Impose" means "to lay on or set as something to be borne, endured, [or] paid,"<sup>232</sup> and is different from "require."<sup>233</sup> Fees that are "imposed" include fees that are "required," but can embrace a wide variety of other fees. Creditors outsource origination and other functions to third parties. The cost of these services, even if set independently by the third party, are finance charges because the consumers incur the expense. One example is the cost for the activities performed by closing agents on behalf of mortgage lenders.<sup>234</sup>

The Board has equated "imposed" by the creditor and "incurred" by the consumer on at least two occasions. The first was in 1995 when the Board proposed new Commentary to address the finance charge status of debt cancellation agreements.<sup>235</sup> Where debt cancellation agreements were not

230 Keest, *supra* note 3, at 361.

231 RENUART & KEEST, *COST OF CREDIT*, *supra* note 12, § 11.6.4.

232 THE RANDOM HOUSE DICTIONARY 451 (1980). See also BLACK'S LAW DICTIONARY 888 (4th ed. 1968) ("to levy or exact as by authority; to lay as a burden, tax, duty, or charge").

233 "Require" means "[to] direct, order, demand, instruct, command, claim, compel, request, need, exact." BLACK'S LAW DICTIONARY 1468 (4th ed. 1968).

234 TILA currently says that closing agent fees are finance charges if, among other things, the creditor requires the services provided. Cf. *First Acadiana Bank v. FDIC*, 833 F.2d 548 (5th Cir. 1988) (finding that requirement and retention of a fee by a third party is not relevant to finance charge status of a fee).

235 Truth in Lending, 60 Fed. Reg. 62,764 (proposed Dec. 7, 1995) (to be codified at 12 C.F.R. pt. 226). A debt cancellation agreement requires the lender to cancel payment on the consumer's loan if certain events transpire, such as "death, serious illness or injury, unemployment, or loss of collateral securing the loan," in exchange for a fee paid by the consumer. RENUART & KEEST, *supra*

treated as credit insurance under state law, the Board stated that the premium fell within the finance charge definition, even though the consumer could choose the coverage.<sup>236</sup> “In other words, according to the proposal, a charge is ‘imposed’ . . . whenever it is incurred by the consumer in connection with the credit transaction, even if voluntarily.”<sup>237</sup>

When finalizing the regulation, the Board, in effect, supported the proposition that “imposed” means “incurred.”<sup>238</sup> Thus, an incurred charge, even one chosen voluntarily, can be a finance charge. For example, fees charged by mortgage brokers are finance charges, even where the lender does not require the use of the broker.

The second occasion occurred when the Board sought public input on “the feasibility of treating as finance charges all costs imposed by the creditor or payable by the consumer as an incident to the extension of credit.”<sup>239</sup> The agency’s position was clear: “The term ‘imposed’ is interpreted broadly, to include any cost charged by the creditor (unless otherwise excluded), including charges for optional services paid by the consumer.”<sup>240</sup>

Congress itself sidestepped, for good reason, the issue of so-called “optional” charges when crafting the general finance charge definition.<sup>241</sup> The question of when a fee is required or optional creates a factual quagmire in

note 12, § 8.3.2.3. Debt cancellation products may be more attractive to lenders than credit insurance since many states do not regulate debt cancellation agreements but do regulate credit insurance. *Id.*

236 60 Fed. Reg. at 62,765.

237 Rohner & Durkin, *supra* note 88, at 178.

238 The Board required creditors to disclose debt cancellation charges consistently with credit life insurance premiums, regardless of state law treatment of debt cancellation agreements. 12 C.F.R. § 226.4(d) (2007). When issuing this rule, the Board stated:

The Board believes that a debt cancellation fee charged by the creditor satisfies the definition of a finance charge because it is part of the cost of the credit. The TILA defines a finance charge to include any charge imposed as an incident to the extension of credit. The Board has interpreted this definition to include any fee charged by the creditor in connection with the loan, if it is not charged in comparable cash transactions and is not subject to an express exemption. The Board has generally taken a case-by-case approach in determining whether particular fees are “finance charges,” and does not interpret Regulation Z to automatically exclude all “voluntary” charges from the finance charge. As a practical matter, most voluntary fees are excluded from the finance charge under the separate exclusion for charges that are payable in a comparable cash transaction, such as fees for optional maintenance agreements or fees paid to process motor vehicle registrations. In the case of debt cancellation agreements, however, the voluntary nature of the arrangement does not alter the fact that debt cancellation coverage is a feature of the loan affecting the total price paid for the credit.

61 Fed. Reg. 49,237, 49,239 (Sept. 19, 1996). The Board implicitly rejected the reasoning of the Seventh Circuit in *McGee v. Kerr-Hickman Chrysler Plymouth, Inc.*, 93 F.3d 380 (7th Cir. 1996), which held that the charge for debt cancellation coverage was not a finance charge because the coverage did not affect the credit terms of the loan itself. Other commentators have recognized that the Board uses “imposed” and “incurred” interchangeably. *E.g.*, Rohner & Durkin, *supra* note 88, at 178-179.

239 Truth in Lending, 60 Fed. Reg. 66,179 (Dec. 21, 1995).

240 *Id.* at 66,180.

241 However, later in section 1605, Congress included charges for optional credit-related insurance products in the finance charge unless the consumer’s decision to buy the insurance is not a factor in the approval of the extension of credit, this fact is clearly disclosed in writing, and the consumer gives specific affirmative written indication of her desire to obtain the credit insurance. 15 U.S.C. § 1605(b) (2000).

every instance and unnecessarily complicates the disclosure regime. For example, should each time the consumer “chooses” to pay a fee trigger disclosures to the consumer about the voluntary nature of this decision? Disputes about whether the charge was truly voluntary arise regularly, particularly in the credit insurance context.<sup>242</sup>

### C. “As an Incident to the Extension of Credit”

The third component makes clear that the fee must be “related to,” “connected to,” or “part of” the extension of credit. This criterion eliminates fees from the finance charge if they have no relation to the extension of credit.

The 1968 edition of Black’s Law Dictionary defined “incident” as denoting “anything which is usually connected with another, or connected with some purposes, though not inseparably.”<sup>243</sup> Thus, to be part of the finance charge, the fee must be “connected to” the extension of credit. By not stating that the fee must be “significantly” or “substantially” (as opposed to “remotely”) related to the extension of credit, Congress spoke loudly that the definition was meant to be inclusive.<sup>244</sup> This phrase rejects the suggestion that the charge be “material” to the credit terms. The notion of materiality has had no place in the finance charge definition to date.<sup>245</sup> If it were injected into the

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242 See, e.g., *Brugger v. Elmhurst KIA*, 2001 U.S. Dist. LEXIS 10298 (N.D. Ill. July 18, 2001); *Hager v. Am. Gen. Fin., Inc.*, 37 F. Supp. 2d 778 (S.D. W. Va. 1999); *Slovak v. Am. Gen. Fin., Inc.*, No. 98-13416 DAS, 1998 WL 830656 (E.D. Pa. 1998); *Kamniski v. Shawmut Credit Union*, 494 F. Supp. 723 (D. Mass. 1980); *In re Milbourne*, 108 B.R. 522 (Bankr. E.D. Pa. 1989); cf. John M. Sheffey, *Credit Life and Disability Insurance Disclosures Under Truth-In-Lending: The Triumph of Form over Substance*, 8 FLA. ST. U. L. REV. 463, 477-90 (1980) (criticizing *USLIFE Credit Corp.*). See generally *USLIFE Credit Corp. v. FTC*, 599 F.2d 1387 (5th Cir. 1979) (holding that if the proper paper disclosures were made, the parol evidence rule bars extrinsic evidence on the issue of voluntariness in the absence of an allegation of consumer illiteracy, fraud, or duress); Truth in Lending (Regulation Z), 12 C.F.R. pt. 226, supp. I, § 226.4(d) cmt. 5 (2007) (Official Staff Interpretations) (stating that whether insurance is voluntary or required is a factual issue). Since the Supreme Court required deference to Board opinions in interpreting TILA in *Ford Motor Credit Co. v. Milhollin*, 444 U.S. 555 (1980), *USLIFE* should have no precedential value, given the Board’s express statement that voluntariness is a question of fact.

243 BLACK’S LAW DICTIONARY 904 (4th ed. 1968).

244 The original version of the Act did not provide for any exclusions from the finance charge. S. 5, 90th Cong. (as introduced, Jan. 11, 1967). Only a few explicit exclusions were added to the final law. S. 5, 90th Cong. (as enacted by Congress, May 29, 1968). Congress approved only explicit exclusions from the finance charge, and those sparingly. Cf. *Household Credit Serv. Inc. v. Pfenning*, 541 U.S. 232, 240-241 (2004) (observing that while the phrase “incident to” implies some “necessary” connection between the antecedent and its object, TILA does not make clear whether a substantial connection is required or whether merely a remote connection is sufficient).

245 But see 15 U.S.C. § 1635(a) (2000); 12 C.F.R. § 226.15(a)(3) (2007) (providing that the right to rescind a non-purchase money mortgage loan may be extended from three days to three years, if the creditor fails to provide “material disclosures”). However, the Board has identified which disclosures constitute the material disclosures for purposes of the right to rescind. *Id.* § 226.15(a)(3) n.36 (open end home equity plans); *Id.* § 226.23(a)(3) n.48 (closed end refinancing mortgages). It would not be possible to define generally the material terms of credit: contract terms vary from product to product, and creditors constantly and unilaterally change credit card agreements.

mix, the bright lines would fade, if not vanish. Factual disputes about what is material would inevitably proliferate.

In the first edition of Regulation Z, the Board added “or as a condition of” to the definitional text.<sup>246</sup> This language arguably expanded the outer limits of the definitional construct given the use of the “or.” Courts, however, have read it as a further limitation on the reach of the finance charge definition.<sup>247</sup>

Nevertheless, the Board acknowledged the broad meaning of “incident to” in 1996: “The Board has interpreted this definition to include any fee charged by the creditor *in connection with* the loan, if it is not charged in comparable cash transactions and is not subject to an express exemption.”<sup>248</sup>

#### D. “Comparable Cash Transaction” Exception

Congress added the “comparable cash transaction” exception to § 1605(a) in 1980 to exempt items from the finance charge when the same charge was imposed regardless of whether the consumer used cash or credit. The examples given of fees that satisfy this exemption were sales taxes, license fees, and registration fees.<sup>249</sup> As these fees are charged in both cash and credit situations, it makes sense not to include them in the finance charge, as they have nothing to do with the extension of credit. Were these items included in the finance charge, credit would seem more expensive (relative to cash transactions) than it actually is.<sup>250</sup>

However, the intent of this provision—neutrality between cash and credit transactions as a matter of public policy—has no logical application where there is no comparable cash transaction, i.e., in non-purchase money credit

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246 The definition read in pertinent part: “the sum of all charges, payable directly or indirectly by the customer, and imposed directly or indirectly by the creditor as an incident to or as a condition of the extension of credit. . . .” 34 Fed. Reg. 2002, 2004 (Feb. 11, 1969).

247 See, e.g., *First Acadiana Bank v. FDIC*, 833 F.2d 548, 550 (5th Cir. 1987) (holding that “as a condition of” is equivalent to “required” where the bank required a chattel mortgage from its borrowers, necessitating that they pay an avoidable economic cost, the fee of an attorney to prepare the chattel mortgage); cf. *Veale v. Citibank, F.S.B.*, 85 F.3d 577, 579 (11th Cir. 1996) (conflating “as a condition of” with “incident to,” in finding that since the borrowers could have chosen not to pay a Federal Express fee for expedited delivery of payoff checks, it was not a fee imposed as an “incident to” the extension of credit).

248 61 Fed. Reg. 49,237, 49,239 (Sept. 19, 1996) (emphasis added).

249 See S. REP. NO. 96-73, at 12 (1979) (“The bill will eliminate some current confusion by making clear that charges which would also be incurred in a similar transaction for cash, such as sales taxes, license and registration fees, are not to be included in the finance charge.”); S. REP. NO. 96-368, at 26 (1979) (same); see also 46 Fed. Reg. 20,848, 20,854-55 (Apr. 7, 1981) (amending 12 C.F.R. § 226.4(a) to reflect the comparable cash transaction analysis and reiterating congressional intent to exempt “charges imposed uniformly in cash and credit transactions, such as sales taxes or license or registration fees. . . .”); cf. 61 Fed. Reg. 49,237, 49,239 (Sept. 19, 1996) (exempting fees for optional maintenance agreements or to process motor vehicle registrations).

250 Rohner & Durkin, *supra* note 88, at 177 (“[T]he comparable cash transaction criterion . . . may be nothing more than a euphemism for saying that the charge is really not for the credit at all, but reflects a separate purchase only temporally connected to the extension of credit.”).

transactions. Cash transactions comparable to credit *sales* exist; cash transactions comparable to a *loan* of money are nonsensical.<sup>251</sup>

In this latter context, the regulatory fault line broke down when the Board addressed checking account fees. There, Regulation Z allows lenders to exclude overdraft loan fees from the finance charge to the extent that the fee does not exceed that imposed for a similar account without a credit feature.<sup>252</sup> However, the use of a check as a payment mechanism is not directly comparable to a loan.<sup>253</sup> More importantly, equating, as the Board has, non-sufficient fund (NSF) charges and overdraft loan fees ignores the economic realities of the transactions. NSF charges and overdraft fees are not cash and credit alternative means of completing the same transactions. NSF fees are penalties for consumer mistakes; no extension of credit is necessarily associated with them. Overdraft fees are charges for the use of highly marketed short-term credit.

Originally, the Board only addressed account activity and maintenance fees, not fees for the extension of credit itself. The 1969 version of Regulation Z stated in a footnote to § 226.4(b)(2) that checking account charges were finance charges to the extent they exceeded “any charges the customer is required to pay in connection with such an account *when it is not being used to extend credit*.”<sup>254</sup> The Board underscored this position in 1980 when it listed examples of fees that were not intended to be finance charges, such as the cost of checking account maintenance.<sup>255</sup> At that time, the Board apparently did not intend § 226.4(b)(2) to exempt charges specifically imposed for the extension of credit itself. This history indicates that the Board necessarily assumed that the “charge” at issue was for *the same service, feature, or product*. It does not make sense to exempt from the finance charge definition a cash advance fee simply because it does not exceed the fee for a completely different service, such as a wire transfer.

251 ROHNER & MILLER, *supra* note 88, ¶ 3.02[2][a][ii] (opining that the comparable cash exclusion does not apply to fees imposed in both the cash advance or bank account overdraft situation because the rule “simply does not apply;” when this exclusion does not apply, one should determine whether other available guidance suggests the answer).

252 12 C.F.R. § 226.4(b)(2) (2007); *see also* Truth in Lending (Regulation Z), 12 C.F.R. pt. 226, supp. I, § 226.4(b)(2) cmt. 1 (2007) (Official Staff Interpretations) (providing illustrations of these distinctions). Overdraft loans occur when a bank covers a consumer overdraft. Usually, this coverage is done automatically, may be done at an ATM or point of sale without the consumer’s knowledge, and does not require the consumer’s consent. Banks charge a flat fee for this “service” and sometimes a daily fee. *See generally* CTR. FOR RESPONSIBLE LENDING, OVERDRAFT LOANS TRAP BORROWERS IN DEBT (2006), available at <http://www.responsiblelending.org/pdfs/FINAL-Overdraft-Brief-Dec-06.pdf>.

253 *Cf.* Rohner & Durkin, *supra* note 88, at 177 (“[I]t is difficult to invoke the comparable cash transaction reference point in evaluating a post-account opening charge in an open-end credit plan, such as for expedited payment or expedited delivery of a card; there simply is no cash transaction to which to compare it.”).

254 Truth in Lending, 34 Fed. Reg. 2002, 2004 n.2 (Feb. 11, 1969) (emphasis added).

255 Truth in Lending, 45 Fed. Reg. 29,702, 29,707 (May 5, 1980) (clarifying “that the portion of *checking account maintenance fees* that are attributable to the existence of a credit feature (for example, overdraft lines of credit) are included in the finance charge”) (emphasis added).

Despite the conceptual problems, the Board excluded overdraft loans from TIL coverage in 2005, presumptively deciding that the fees were not finance charges.<sup>256</sup>

### VIII. Recent Board Activity Related to a Fee-Inclusive APR

Despite the Board's historical pattern of expanding the exclusions to the finance charge definition, it endorsed a highly inclusive definition of the finance charge in a joint report issued by it and the Department of Housing and Urban Development in 1998.<sup>257</sup> While that report focused on mortgage transactions and no legislative or regulatory changes occurred as a result, the Board's position is instructive.

The agency asked whether the finance charge and APR disclosures should be eliminated, or modified and retained. The Report described the APR as a useful shopping tool for borrowers because a single figure is simple to use.<sup>258</sup> Consumers can evaluate loan products using one variable. Moreover, the APR has a forty year history in the mental fabric of consumers. Consumers attending a Board focus group in 1997 generally favored retaining it. Finally, "the APR concept deters hidden or 'junk' fees to the extent that the fees must be included in the APR calculation."<sup>259</sup>

The Board was guided in its deliberations about modifications to the APR and finance charge definition by three standards:

- (1) credit costs must be fully disclosed so that consumers know all the terms and are better able to decide which offer to accept; (2) the cost of credit should be stated in terms that consumers understand so that comparing costs among creditors is easy; and (3) the cost of credit from all creditors should be stated comprehensively and uniformly to promote comparison shopping and competition.<sup>260</sup>

The Board urged that the finance charge include "the costs the consumer is required to pay to get the credit" and exclude charges payable in a comparable cash transaction. Under this standard, most fees incurred by a consumer in a mortgage transaction would be treated as finance charges: credit report, appraisal, lender inspection, pest inspection, tax or flood certification, document preparation, settlement, abstract or title search, title insurance (lender's coverage), notary, lender attorney fee, and recording mortgage or

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256 Truth in Savings, 70 Fed. Reg. 29,582 (May 24, 2005).

257 FRB/HUD REPORT, *supra* note 20, at 16. These agencies undertook this project as a result of direction from Congress in the Economic Growth and Regulatory Paperwork Reduction Act of 1996. Pub. L. No. 104-208, 110 Stat. 3009 (1996). The agencies concluded that the reforms they recommended should be accomplished primarily by legislative rather than regulatory changes. FRB/HUD REPORT, *supra* note 20, at 2.

258 FRB/HUD REPORT, *supra* note 20, at 9.

259 *Id.*

260 *Id.* at 12.

release fees.<sup>261</sup> The APR would then become a more accurate and reliable measurement of the cost of credit. Further, a more inclusive definition would create brighter lines for creditors and reduce creditor judgment calls.<sup>262</sup>

Subsequently, on December 8, 2004, the Board issued an Advance Notice of Proposed Rulemaking.<sup>263</sup> This Notice signaled the beginning of the Board's most systematic review of Regulation Z since 1980.<sup>264</sup> The Board proposed to conduct this process in stages. This first phase covered the rules governing open-end credit, with an emphasis on credit card transactions.<sup>265</sup>

The stated goals were five: 1) to improve the usefulness of open-end disclosures; 2) to consider concerns about information overload; 3) to study alternatives to improve the format of disclosures; 4) to improve the substantive protections included in the Act, particularly those addressing inaccurate and unfair billing practices; and 5) to facilitate creditor compliance and ease unnecessary regulatory burden.<sup>266</sup>

The Advance Notice posed fifty-eight questions for comment. Approximately thirteen sought information and opinion on issues related to the finance charge definition, the periodic statement APR, and tolerances.<sup>267</sup> After the comment period closed on March 28, 2005, the Board convened consumer focus groups to provide feedback about credit card disclosures, including the periodic statement APR.<sup>268</sup> The Board published proposed amendments to Regulation Z and the Official Staff Commentary on June 14, 2007.<sup>269</sup> A detailed discussion of these extensive changes is beyond the scope of this Article.<sup>270</sup>

261 *Id.* at app. C.

262 *Id.* at 15-16; *cf.* Rohner & Durkin, *supra* note 88, at 184 (noting that the Board "reaffirmed its general commitment to an 'all-in' finance charge principle, or at least to the view that voluntarily incurred charges are presumptively finance charges" in the context of addressing the status of debt cancellation fees in 2003).

263 Truth in Lending, 69 Fed. Reg. 70,925 (Dec. 8, 2004).

264 *Id.* at 70,926.

265 *Id.* The Board announced that it would review Regulation Z in the context of closed-end mortgage credit, predatory lending, home equity lines of credit, and adjustable-rate mortgage loans in subsequent stages. *Id.* at 70,935-36. As of October 2007, the Board had not started the other stages of its regulatory overhaul.

266 *Id.* at 70,926.

267 See Truth in Lending, 69 Fed. Reg. at 70,930-33 (questions 13, 15-21, 23-25, 37).

268 MACRO INT'L, INC., *supra* note 27; see also Truth in Lending Act, 72 Fed. Reg. 32,948, 32,955 (June 14, 2007) (describing how the focus groups were used to test their understanding of the APR).

269 Truth in Lending Act, 72 Fed. Reg. 32,948 (June 14, 2007). The public comment period ended on October 12, 2007. As of the publication date of this article, the Board has not issued final regulations.

270 This voluminous document suggests, among many other proposals, utilizing the tabular disclosures of rates and fees currently provided only at the solicitation and application stages (called the "Schumer" box) when the account is opened, on the periodic statements, and on change in terms notices. The Board also would require creditors to segregate interest costs and fees from the consumer's purchase and advances on the periodic statements, making those costs more readily apparent to the consumer. *Id.* at 32,954-56.



Relevant to this Article, the agency recommends that: any transaction fee on a credit card plan be treated as a finance charge (the example involves ATM charges); debt suspension fees be subject to the debt cancellation exclusionary rule; and purchases of credit insurance after account opening trigger disclosure and consent requirements (with oral disclosure and consent permitted in telephone sales) to avoid finance charge status.<sup>271</sup>

In addition, the Board proposes two alternatives for the disclosure of the periodic statement APR—to add more of the account fees into the finance charge but allow the disclosure of separate APRs for each feature and related fees incurred in the previous month, or to eliminate it entirely.<sup>272</sup>

A more fee-inclusive APR would give consumers a clearer picture of the costs of credit incurred in the previous month. It could help consumers decide each month whether to continue using the account, to shop for another credit product, or to rely upon an alternative means of payment such as a debit card. The more “fully loaded” APR can alert consumers that the overall cost of the credit exceeds the advertised APR.<sup>273</sup> However, the multiple APRs would clearly undermine the disclosure of any one APR: no longer would the APR be the number to shop on; instead, borrowers would have to choose which APR to shop on. In addition, the Board’s proposal would dilute the impact of fees on the APR, by disaggregating the fees into separate APRs. Finally, using a closed list of finance charges likely would encourage fee proliferation. Lenders would only need to find another way to characterize a fee in order to take it “off the TILA chessboard.”<sup>274</sup>

The Board is poised between condemning the APR to useless irrelevancy and marginally, if at all, improving the capacity of the APR to tell the consumer the truth. Neither proposal advances TILA’s original goals. Instead, we suggest that Congress and the Board return heft to the APR by making it a fee-inclusive yardstick.

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271 *Id.* at 32,963-67.

272 *Id.* at 32,955-56, 39,996-99 (amending 12 C.F.R. §§ 226.7(a)(7), 226.7(b)(6)(iv)). The additional fees are limited to five types: periodic interest, transaction charges, mandatory credit insurance and debt cancellation coverage, minimum finance charges, and account activity/balance fees. Truth in Lending Act, 72 Fed. Reg. at 33,063 (proposing 12 C.F.R. § 226.14(e)). Creating a closed universe of countable fees likely will encourage a proliferation of fees that do not fall into these pigeonholes and result in a weak APR. To complicate matters, composite APRs for two or more types of fees would be eliminated. The creditor must disclose a separate APR for each fee type incurred each month. Consumers could be hit with multiple APRs on any given monthly statement.

273 Truth in Lending Act, 72 Fed. Reg. at 32,956. *See also Improving Credit Card Consumer Protection: Recent Industry and Regulatory Initiatives: Hearing Before the Subcomm. on Financial Instruments and Consumer Credit of the H. Comm. on Financial Services*, 110th Cong. 216-17 (2007), (testimony of Kathleen E. Keest, Senior Policy Council, Ctr. for Responsible Lending) (using the term “fully-loaded APR” and discussing why a fee-inclusive APR is essential), available at [http://www.house.gov/apps/list/hearing/financialsvcs\\_dem/press060707.shtml](http://www.house.gov/apps/list/hearing/financialsvcs_dem/press060707.shtml).

274 Rohner & Durkin, *supra* note 88, at 150.

## IX. Finance Charge Litmus Test: Drawing Clear Lines

The statutory definition of the finance charge suggests a “but for” test to determine when a particular fee is or is not a finance charge. We offer the following question as the litmus test: If the consumer were not obtaining, accessing, or repaying the extension of credit, would the consumer be paying the fee directly or indirectly?

This question faithfully embodies each of the elements in TILA’s general definition. The “but for” test weeds out fees paid in comparable cash transactions. The answer to this question creates bright lines for consumers, creditors, and governmental enforcement agencies when assessing whether fees fall in or out. This test simplifies creditor compliance and allows consumers to shop efficiently.<sup>275</sup>

Recall that TILA has three definitional prongs: 1) payable directly or indirectly by the consumer; 2) imposed directly or indirectly by the creditor; and 3) incident to the extension of credit. The litmus question explicitly includes the first prong. The second and third prongs require more explanation.

The litmus test is faithful to the second prong because it captures all of the charges the consumer “incurs” in connection with the extension of credit. And, consistent with the general definition in the Act, the litmus test does not distinguish between “optional” and “required” charges.

Finally, the litmus question captures whether the fee is for a service, product, or cost “connected or related to” the extension of credit. First, this test preserves the statutory distinction between cash and credit transactions because the fee must be attributable to the credit aspect of the deal. Second, Congress did not limit the phrase “extension of credit” to those costs associated with getting the credit in the first instance. Comparison shopping requires an APR that reflects the cost of obtaining, accessing, and repaying the extension of credit.<sup>276</sup> This is true whether in the context of closed-end credit, where the origination costs are static, or in open-end credit, where the actual costs are only determined after the extension of credit.

The test we propose provides clearer guidance to creditors as to which fees to include in the finance charge. Indeed, the test creates very short lists of items that may be *excluded*, resulting in a relatively easy decision-making process for creditors. Bright lines should reduce the expenses of compliance and litigation, which lenders should welcome.<sup>277</sup> As we have noted, creditors

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275 See Bar-Gill, *supra* note 171, at 54 (“If a mortgage lender or a credit card issuer is required to calculate for the consumer and explicitly state the total (or expected) interest and fee payments over the life of the loan, then consumers will be more likely to balance this total cost information against the short term perks offered by the lender or issuer on a bundled product.”).

276 Cf. Rohner & Durkin, *supra* note 88, at 170 (observing that the expenses of “origination, servicing, funding, and risk” can be finance charges).

277 The current fee-by-fee approach confuses even real estate attorneys. Gwen Seaquist & Alka Bramhandkar, *The Whole Truth? The Problem with “Truth in Lending,”* N.Y. ST. B. ASS’N J.,

have powerful incentives to pack additional products that are not reflected in the APR into the sale of credit because their price tags appear lower than their competitors’.

## X. Applying the Litmus Test: Where the Fees Fall

This Part categorizes some of the most common fees that appear in credit card agreements, car loans, and mortgage loans under the “but for” question. If section 1605 contains a subsection excluding the fee from the finance charge, we so indicate.

### A. Credit Cards

#### 1. Fees Included Under the Test

The following common fees are finance charges using the “but for” test:<sup>278</sup> annual and participation, cash advance, balance-transfer, late payment, over-limit, credit-limit-increase, set-up, return-item, and credit insurance or debt cancellation/suspension fees.<sup>279</sup> Of the charges on this list, only cash advance and balance-transfer costs are finance charges under the current Regulation Z and the Commentary. However, the others meet the litmus test because they would not be incurred by the consumer but for the extension or repayment of credit. For example, a consumer would not pay a credit card plan annual, participation, over-limit, set-up, or credit insurance fee in a cash transaction.

One very important difference with closed-end credit arises here. Because the credit relationship with the consumer revolves (and evolves due to changes in terms) in a credit card plan, TILA mandates disclosures of costs incurred during the entire life of the contract on the periodic statements. It makes sense to disclose all post-origination costs related to the credit plan each month as they arise.<sup>280</sup> In contrast, consumers only receive one disclosure of the cost of

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June 2006, at 30, 33 (of 19 surveyed practicing real estate attorneys and finance professors, less than half could identify the fees included in the APR).

278 It is worth noting that the federal banking agencies define “interest” (always part of the finance charge under TILA) to include annual, cash advance, balance-transfer, late payment, over-the-credit limit, credit-limit-increase, set-up, and return-item fees. 12 C.F.R. § 7.4001(a) (2007).

279 Note that Congress excluded credit insurance from the general definition if certain conditions are met and disclosures provided. 15 U.S.C. § 1605(b)-(c) (2000). The Board treats debt cancellation contracts in the same fashion as credit life, accident, and health premiums. 12 C.F.R. § 226.4(d) (2007). Late payment fees must be unanticipated to be excluded. 12 C.F.R. § 226.4(c)(3) (2007).

280 See 72 Fed. Reg. 32,948, 32,965 (June 14, 2007) (to be codified at 12 C.F.R. pt 226) (“Consumers with open-end plans, however, retain the ability to obtain advances of funds long after account opening. . . . That is, a consumer can engage in credit transactions throughout the life of a plan.”).

the credit in closed-end transactions—at consummation. Costs not actually incurred or anticipated at the time, such as late payment fees and prepayment penalties, are not included in the APR. However, late fees should be reflected in the APR on the periodic statements, as they meet the litmus test. Consumers then can see the total cost of incurring such fees and either alter their behavior or shop for a less expensive card.

## 2. Fees Excluded Under the Test

The following credit card fees may not be finance charges under our proposed test if the credit card issuer provides a free and equally reliable method of access or payment to the customer: expedited payment charges; expedited delivery fees; and replacement card fees where the replacement card is not required by the creditor or where the consumer's card has not been lost or stolen and the card is not the consumer's only access to credit through the plan. These charges are excluded under the test because the consumer can access and repay the credit through other no-cost and equally reliable methods.

### B. *Car Loans (Closed-End)*

## 1. Fees Included Under the Test

The following common charges fall within the finance charge definition when applying our test: document preparation fees, as long as charges in identical amounts are not charged routinely to cash customers; dealer discounts; credit report and credit report review fees; credit insurance or debt cancellation/suspension fees; premiums payable for any insurance in lieu of perfecting any security interest required by the creditor; and governmental fees to perfect a security interest.<sup>281</sup> These are all costs associated with the credit terms<sup>282</sup> and would not be incurred in a cash transaction. Credit insurance affects the payment schedule if the triggering event results in a payment to the account on the consumer's behalf. Debt suspension coverage permits the deferral of payments when specified incidents occur in the consumer's life.

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281 Note that Congress excluded premiums payable for any insurance in lieu of perfecting any security interest required by the creditor and governmental fees to perfect a security interest from the general definition. 15 U.S.C. § 1605(d) (2000).

282 Rohner and Durkin suggest that the "essential credit terms" include "the amount of credit or credit line, the time of the availability of funds or the consumer's means of accessing a credit line, the schedule of payments (including minimum payments in an open-end plan); and the medium through which payments are made." Rohner & Durkin, *supra* note 88, at 203.

Of this list, only credit report and review fees currently are per se finance charges. The other charges are excluded routinely when certain conditions are met.<sup>283</sup>

## 2. Fees Excluded Under the Test

The following fees would not cross the finance charge line: sales taxes and license tag fees, notary fees, and fees to file car registration that are incurred by cash and credit customers alike; automobile club fees, as long as the club fees are not required by the creditor and do not affect the terms of the credit agreement; extended warranty premiums, as long as the fees are not required by the creditor (or if required then are charged to credit and cash customers alike) and the extended warranties do not affect the terms of the credit agreement. None of these costs would be finance charges under the current regulatory regime.

### C. *Mortgage Loans (Closed-End)*

#### 1. Fees Included Under the Test

Here, virtually all of the dozens of fees that can and do appear at the closing on a mortgage loan would fall within the definition. The most common include: origination, discount, broker, appraisal, service, credit report, credit report review, application, underwriting, processing, credit insurance, mortgage insurance, settlement or closing, title related, document preparation, notary (for loan and mortgage documents but not for the deed if a purchase money loan), pest inspection, delivery, mailing, walking to the courthouse, escrow withholding, and assignment fees. Many of these costs currently are excluded from the definition.<sup>284</sup> However, they are captured by the litmus test because the consumer incurs them when obtaining the credit.

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283 See, e.g., 12 C.F.R. § 226.4(d) (2007) (discussing conditions under which credit insurance and debt cancellation charges are excluded); 12 C.F.R. § 226.4(e) (2007) (discussing conditions under which taxes to perfect a security interest and insurance in lieu of filing a security interest are excluded).

284 TILA specifically excludes several of these fees, such as the title-related fees, document preparation, escrows, notary, appraisal, pest inspection, flood determination, and credit report charges when the loan is secured by real property. 15 U.S.C. § 1605(e) (2000). Regulation Z narrows this blanket exclusion by providing that these fees must be bona fide and reasonable to be left out of the finance charge. 12 C.F.R. § 226.4(c)(7) (2007). Closing agent and title and escrow company fees are omitted from the finance charge if the creditor does not require the imposition of the charge or the service provided and does not retain the charges. 15 U.S.C. § 1605(a). These exclusions, available only to a mortgage lender, make a mortgage loan look cheaper than a non-mortgage loan, and may unfairly bias a consumer who has a choice between a mortgage or non-mortgage loan to finance a car or home repairs.

## 2. Fees Excluded Under the Test

Costs that are not included in the finance charge when applying the “but for” test include government recording fees or taxes if imposed identically in purchase money transactions.

## XI. A Critique of Other Approaches

When the Board published its Advance Notice in 2004 regarding open-end credit, it identified two substitute definitions of the finance charge:

(1) A fee is a finance charge if payment of the fee is required to obtain credit.<sup>285</sup>

(2) A fee is a finance charge based on whether the fee affects the amount of credit available or the material terms of the credit.<sup>286</sup>

The first test is problematic because it is narrower than that articulated in the Act and existing regulations. As described in Part VII above, the second prong of the statutory definition (“imposed directly or indirectly by the creditor”) is broader than this suggested standard. This standard would exclude certain “voluntary” charges that, under current law, are now included in the finance charge.<sup>287</sup> Further, it would encourage “loan-packing,” a long-standing problem where lenders increase costs to consumers outside the price tag by automatically including so-called “optional” products.<sup>288</sup>

The first test would further erode the usefulness of the APR. Consumers simply cannot shop on multiple terms successfully. Including optional fees in the APR informs consumers of the cost of choosing to incur “add-ons” instead of the stripped-down product and allows consumers to shop for the total cost of credit.

The second approach would complicate the finance charge definition when measured against the third element of the statutory definition (“incident

285 Some industry representatives have suggested a rule that would classify fees as finance charges only if payment of the fee is required to obtain credit. How would creditors determine if a particular fee was optional? Would costs for certain account features be excluded from the finance charge provided that the consumer was also offered a credit plan without that feature? Would such a rule result in useful disclosures for consumers? Would consumers be able to compare the cost of the different plans? Would such a rule be practicable for creditors? Truth in Lending, 69 Fed. Reg. 70,925, 70,930 (proposed Dec. 8, 2004) (to be codified at 12 C.F.R. pt. 226). The Board previously endorsed this test in the FRB/HUD REPORT, *supra* note 20, at III.

286 Some industry representatives have suggested a rule that would classify a fee as a finance charge based on whether the fee affects the amount of credit available or the material terms of the credit. How would such a standard operate in practice? For example, how would creditors distinguish finance charges from “other charges”? What terms of a credit plan would be considered material?

Truth in Lending, 69 Fed. Reg. at 70,930.

287 For example, broker fees, and credit insurance premiums and charges for debt cancellation products if certain conditions are not met, are included. 15 U.S.C. § 1605(a)(6)-(b) (2000).

288 For a discussion of this phenomenon, see RENUART & KEEST, *supra* note 12, § 11.6.4; RENUART & KEEST, *supra* note 19, §§ 3.9.4.1, 3.9.4.5.2.3.

to the extension of credit"). Injecting the concept of materiality creates confusion rather than resolving it. It encourages creditors to create many small fees, which would escape inclusion in the finance charge and cognitive notice by consumers.

Authors Rohner and Durkin posit a third approach. They suggest that the finance charge should consist of the expenses incurred by the creditor arising from origination, servicing, funding, and risk.<sup>289</sup> Thus, finance charges would equal the economic costs of the transaction *to the creditor*. They label these expenses the "economic conception" of the finance charge as the cost of credit.<sup>290</sup> Their article primarily focuses upon so-called "optional charges" and teases out the finance charge status of those types of fees for credit card transactions based upon their suggested standard.<sup>291</sup> However, their proposal has no support in the legislative history or plain language of TILA or Regulation Z. TILA's language and legislative history focus on the costs incurred by the consumer, in order to facilitate the consumer's shopping. Finally, their proposal would encourage "loan-packing," much like the first approach.

Nonetheless, Rohner and Durkin make an important contribution by recognizing that the cost of the transaction does not end at the time the lender extends the credit.<sup>292</sup> In particular, in the credit card and home equity line of credit contexts, the costs to the consumer are dynamic and can occur at different points in time over an extended relationship with the creditor.

Other possible approaches include three mentioned by the Board in the FRB/HUD Report. The Board rejected each for a variety of reasons. The "cost of the transaction" test would include in the finance charge fees for items unrelated to financing, such as sales taxes. The Board noted that "the cost of the transaction" test would change TILA's emphasis from the cost of credit to

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289 Rohner & Durkin, *supra* note 88, at 141; *see also id.* at 170-171.

290 *Id.* at 170.

291 Under their standard,

a fee incurred by a consumer for an optional product or service offered by or through the creditor is not a finance charge if

(a) The fee is designated for a product or service that is voluntarily purchased by the consumer pursuant to an agreement that is severable from or additional to an underlying credit transaction or plan;

(b) The creditor discloses the fee for the product or service to the consumer in a reasonable manner before or at the time the consumer agrees to incur the charge; and

(c) The consumer's purchase, or failure to purchase, the product or service does not alter the amount of the credit, the consumer's access to it, the timing or method of repayment, or the allocation of credit risk, as provided in the underlying transaction or plan.

*Id.* at 202. Based on this analysis, the following *are* finance charges: debt cancellation or suspension charges; fees for the right to switch from an ARM to a fixed rate; subordination fees; charges for electronic payment; skip payment option fees. The following *are not* finance charges: end-of-the-year compilations of credit charges or purchases statements; safe deposit box services; toasters purchased through a billing stuffer; mortgage assignment fees; and expedited payment fees. *Id.* at 203-205, 207 n.152.

292 *See id.* at 170-71.

the cost of the home purchase or other transaction. The Board also refused to adopt a more limited option, the “interest substitute” approach, because the only fees included in the finance charge would be interest plus discount points and other fees related to the interest rate.<sup>293</sup>

The Board identified a third standard, called the “consumer-pay” approach, which is similar to our litmus test.<sup>294</sup> The agency agreed that this methodology offers a more complete price tag for the consumer. However, the Board claimed that “it does not readily permit consumers to compare credit costs because the credit cost is combined with optional expenses, which could vary among creditors and by consumers’ choices.”<sup>295</sup> However, the claimed variations are minor when compared to the benefits of an all-inclusive APR. Consumers, for many reasons, including mental accounting and framing, are not likely to perceive the true cost of optional products when sold in conjunction with credit.<sup>296</sup> Creditors, however, are highly motivated to sell these optional products as a revenue center. Unless the pricing is bundled with the products, consumers are likely to buy more of the optional products than they want in response to clever and aggressive lender marketing.<sup>297</sup> Moreover, creditors could advertise the APR with and without items such as credit insurance or debt cancellation/suspension fees, which are the most expensive “optional” products that are sold only in credit transactions (the cost of products sold in comparable cash transactions would not be a part of the finance charge in any event).<sup>298</sup>

## XII. Responses to Industry Concerns

Lenders often raise the issue of the cost of making disclosures. They are concerned about the costs of compliance with existing law, of retooling systems to accommodate legislative or regulatory changes, and of litigation if errors are made. The industry worries that a more fee-inclusive APR will make their products seem more expensive and perhaps reduce consumer consumption of credit. Finally, lenders argue that the APR is confusing in any event and should be abandoned.<sup>299</sup>

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293 FRB/HUD REPORT, *supra* note 20, at 13-14.

294 *Id.* at 13.

295 *Id.*

296 *See supra* Section V.B.

297 *See, e.g.,* Bar-Gill, *supra* note 171, at 35.

298 Advertising APRs with and without these products is permitted under TILA. *See* 15 U.S.C. §§ 1661, 1662, 1664, 1665a (2000); 12 C.F.R. § 226.24 (2007).

299 *See* Truth in Lending, 72 Fed. Reg. 32,948, 32,955-56 (June 14, 2007) (to be codified at 12 C.F.R. pt. 226) (summarizing these latter two arguments in relation to the periodic statement APR disclosed on credit card billing statements).



A. *The Cost Question*

## 1. Compliance Costs

Given technological innovations, the cost of compliance with all current law (not just TILA) is very inexpensive. In the mortgage lending context, that cost can be as low as \$1 per loan.<sup>300</sup>

As to the cost to retool a lender's system when regulatory changes occur, the Board analyzed data from survey answers obtained from banks following the enactment and implementation of the Truth In Savings Act (TISA) in 1991-1992.<sup>301</sup> This Act is a recent example of the imposition of a new disclosure regime upon the banking industry. The Act applies to depository accounts. It requires written disclosures at account opening, advance notice of adverse changes in account terms, and the inclusion of certain information in periodic account statements.<sup>302</sup> In addition, TISA requires banks to calculate interest based on the full principal balance.<sup>303</sup>

The authors identified TISA compliance costs as follows: cost management and in-house legal services, outside legal counsel and consultants, training, data processing and information system changes, redesign and replacement of disclosure statements, and notification to customers where relevant.<sup>304</sup> Of these expenses, data processing and information system changes accounted for the largest share of the total bank outlay (37.9%), followed by management and in-house legal services costs.<sup>305</sup> Banks reported spending about \$29,390 on average to implement TISA.<sup>306</sup> The price tag was not high.

The cost of tightening up the finance charge definition should be far less than the cost of implementing a new disclosure regime, such as TISA. The

300 DELVIN M. DAVIS & ELLEN SCHLOEMER, CTR. FOR RESPONSIBLE LENDING, STRONG COMPLIANCE SYSTEMS SUPPORT PROFITABLE LENDING WHILE REDUCING PREDATORY PRACTICES 6 (2005), available at [http://www.responsiblelending.org/pdfs/ip010-Compliance\\_Costs-0705.pdf](http://www.responsiblelending.org/pdfs/ip010-Compliance_Costs-0705.pdf) (concluding that automated loan review costs \$1 to compare the loan to state anti-predatory lending laws and \$16 to check the loan against all laws); Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2082 (2007) (concluding that automated compliance review for predatory lending law violations can cost less than \$1 per loan).

301 GREGORY ELLIEHAUSEN & BARBARA R. LOWERY, BOARD OF GOVERNORS, FED. RESERVE SYS., THE COST OF IMPLEMENTING CONSUMER FINANCIAL REGULATIONS: AN ANALYSIS OF EXPERIENCE WITH THE TRUTH IN SAVINGS ACT (1997), available at <http://federalreserve.gov/pubs/staffstudies/1990-99/ss170.pdf>.

302 12 U.S.C. §§ 4301, 4305, 4307, 4313 (2000).

303 12 U.S.C. § 4306 (2000).

304 ELLIEHAUSEN & LOWERY, *supra* note 301, at 8-9.

305 *Id.* at 9.

306 The amount varied from smaller to larger banks, with small banks spending an average of \$16,110, medium sized banks \$25,860, and large banks \$194,270. *Id.* at 8. The large banks benefited from economies of scale. *Id.* at 9-10. Accounting for inflation since 1991, the average cost rises to \$44,343. The inflation calculator used for this example was the Federal Reserve Bank of Minneapolis—Consumer Price Index Calculator, <http://minneapolisfed.org/research/data/us/calc> (last visited Aug. 2, 2007).

change is one of calculation only. A fee-inclusive APR would not require a re-tooling of the mathematical formula or the disclosure forms used. Rather, new fees would be added to the finance charge, and the APR would be calculated using the existing formula. Consequently, increased compliance costs are not a realistic barrier to the changes we suggest.

## 2. Liability Costs

Commentators also argue that the litigation costs can be high due to uncertainty within the disclosure rules.<sup>307</sup> We do not dispute that there is litigation risk. However, as we will show, Congress created plenty of protections from excessive litigation costs in the Act.

First, Congress has, over the years, built generous tolerances into TILA. Overdisclosure of the finance charge never triggers liability for real-estate secured loans.<sup>308</sup> In the rare case where the answer to the litmus test is unclear, lenders can treat the fee as a finance charge and avoid liability.

Second, the numerical tolerances for underdisclosures of the finance charge in the mortgage context range from a high of 1% of the principal if the consumer is suing to rescind a mortgage loan that refinanced a previous loan with the same lender<sup>309</sup> and ½ of 1% of the principal of the loan if the consumer is suing to rescind other non-purchase mortgage loans,<sup>310</sup> to \$100 if the consumer is suing for monetary damages,<sup>311</sup> to \$35 in the exigent circumstance where a consumer defends herself in a foreclosure action by asserting rescission.<sup>312</sup> The percentage-based tolerances translate into large error forgiveness. For example, 1% of a \$200,000 loan equals \$2,000; ½ of 1% is \$1,000. Tolerances for car loans are smaller, as are the loans themselves. In that situation, the creditor must be within \$10 of the correct finance charge, if the amount financed exceeds \$1,000.<sup>313</sup> Finally, quite apart from errors in the finance charge disclosure, creditors can under- or over- disclose the APR by up to .125% or .250%, depending on the type of loan.<sup>314</sup>

307 *E.g.*, Rohner & Durkin, *supra* note 88, at 139.

308 15 U.S.C. § 1605(f)(1)(B) (2000).

309 *Id.* § 1605(f)(2)(B).

310 *Id.* § 1605(f)(2)(A).

311 *Id.* § 1605(f)(1)(A).

312 *Id.* § 1635(i)(2).

313 12 C.F.R. § 226.18(d)(2) (2007). There is no finance charge tolerance in the credit card context, presumably because the issue only arises on the periodic statement when charges actually incurred are listed and the effective APR is disclosed. In that case, the actual fee amounts are small, ranging from \$1 to \$50.

314 15 U.S.C. § 1606(c) (2000); 12 C.F.R. § 226.14(a) (2007) (the tolerance of .125% applies to fixed or variable rate open-end plans); 12 C.F.R. § 226.22(a)(3) (larger tolerance of .250% for irregular transaction permitted in closed-end loans; an example of an irregular transaction is a variable rate mortgage loan sporting a teaser rate); *see also* 15 U.S.C. § 1602(z) (2000) (appearing to permit the overdisclosure of any amount that must be provided to the consumer). *But see* Barber v. Knox County Sch. Employees Credit Union (*In re* Cox), 114 B.R. 165 (Bankr. C.D. Ill. 1990) (holding that 15 U.S.C.

Third, TILA provides other shelters for creditors. For example, the statute of limitations for affirmative damages cases is only one year.<sup>315</sup> Rescission of non-purchase money mortgage loans ends at three years and the right only applies to a limited list of violations.<sup>316</sup> Creditors are not liable for acts done or omitted in good faith in conformity with any Board rule, regulation, or interpretation.<sup>317</sup> The Board has created numerous model forms that creditors may use when making disclosures, thus eliminating much of the guesswork.<sup>318</sup> Creditors may also escape liability if they can show that the violation was not intentional and resulted from a bona fide error despite the maintenance of procedures reasonably adapted to avoid any such error.<sup>319</sup> Finally, if errors in the disclosure of the APR or finance charge are caused by a corresponding error in the calculation tool and the creditor discontinues use of the tool, the creditor is not liable.<sup>320</sup>

Fourth, the damages provisions of the Act are not onerous. Consumers may seek statutory damages of up to \$2,000 in real-estate secured loans and up to \$1,000 in all other transactions.<sup>321</sup> Statutory damages are further limited in a class action or a series of class actions involving the same violations by the same creditor. There the award cannot exceed more than \$500,000 or 1% of the creditor's net worth, whichever is smaller, regardless of the number of class members.<sup>322</sup> The consumer is entitled to only one statutory award even where there are multiple disclosure violations.<sup>323</sup> Multiple obligors can only recover damages once.<sup>324</sup> Not all violations of the Act trigger statutory damages.<sup>325</sup> A few courts interpret this limitation to contain a closed list of violations which significantly reduces potential creditor liability.<sup>326</sup> The Act also permits the

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§ 1602(z) does not grant a blanket defense to creditors for disclosing a higher APR than the correct one); *Williams v. Chartwell Fin. Servs., Ltd.*, 204 F.3d 748 (7th Cir. 2000) (adopting the *Cox* reasoning).

315 15 U.S.C. § 1640(e) (2000). The consumer can raise a damage claim as a defense by way of recoupment in an action filed by the creditor at any time, however. *Id.*

316 15 U.S.C. § 1635(f) (2000); 12 C.F.R. §§ 226.15(a)(3), 226.23(a)(3) (2007).

317 15 U.S.C. § 1640(f) (2000).

318 12 C.F.R. pt. 226, app. G, H (2007).

319 15 U.S.C. § 1640(c) (2000).

320 12 C.F.R. § 226.14 n.31a (2007) (open-end credit); *Id.* § 226.22 n.45d (closed-end credit).

321 15 U.S.C. § 1640(a)(2)(A) (2000); *Koons Buick Pontiac GMC, Inc. v. Nigh*, 543 U.S. 50, 53 (2004) (interpreting § 1640(a)(2)(A) to mean that the \$1,000 cap applies to all loans other than mortgage loans). Congress has not raised the \$1,000 award cap since 1968. When one takes into account the rate of inflation that has occurred since then, the damage amount ought to be set at almost \$6,000. The inflation calculator used for this example was the Federal Reserve Bank of Minneapolis—Consumer Price Index Calculator, *supra* note 306. Congress added the \$2,000 award that applies in real-estate secured loans in 1995. Truth in Lending Act Amendments of 1995, Pub. L. No. 104-29, § 6, 109 Stat. 271, 274 (1995). The value of \$2,000 in 1995 dollars today is approximately \$2,700.

322 15 U.S.C. § 1640(a)(2)(B).

323 *Id.* § 1640(g).

324 *Id.* § 1640(d).

325 *Id.* § 1640(a) (paragraph following § 1640(a)(4)).

326 See, e.g., *McDonald v. Checks-N-Advance, Inc.* (*In re Ferrell*), 358 B.R. 777, 788 (B.A.P. 9th Cir. 2006); *Baker v. Sunny Chevrolet, Inc.*, 349 F.3d 862, 866 (6th Cir. 2003); *Brown v. Payday Check Advance*, 202 F.3d 987, 991 (7th Cir. 2000).

consumer to seek actual damages,<sup>327</sup> but several courts require the consumer to show detrimental reliance on the erroneous disclosure, making actual damages very difficult to obtain.<sup>328</sup>

The rescission remedy, available to consumers only in non-purchase money mortgage loans, can come with a significant price tag for the offending lender. When a loan is rescinded, the lender must subtract from the principal all closing costs incurred and all payments made by the consumer up to the date of a judgment.<sup>329</sup> Nevertheless, the finance charge tolerances temper the potential for liability, except where the consumer is defending against a foreclosure. Moreover, the three-year right to cancel is triggered only when the lender violates one of only a handful of the most important of the Act's requirements.<sup>330</sup> Two appellate courts have held that rescission is not available in a class action, further limiting potential liability.<sup>331</sup>

Fifth, Congress granted enforcement authority under TILA to the federal supervisory agencies of the various types of depository institutions.<sup>332</sup> The Federal Trade Commission is charged with the responsibility of enforcing the Act against lenders not specifically covered by the other agencies.<sup>333</sup> Pursuant to this authority, these agencies conduct examinations and may order adjustments to consumer accounts if the APR and finance charge disclosures are inaccurate.<sup>334</sup> However, the agencies can order restitution only where the error exceeds certain tolerances and there is a clear and consistent pattern or practice of violations, where the violation resulted from gross negligence, or where the lender willfully intended to mislead the person to whom the credit

327 15 U.S.C. § 1640(a)(1).

328 See, e.g., *Smith v. Gold Country Lenders*, 289 F.3d 1155, 1157 (9th Cir. 2001); *Turner v. Beneficial Corp.*, 242 F.3d 1023, 1028 (11th Cir. 2001); *Perrone v. Gen. Motors Acceptance Corp.*, 232 F.3d 433, 439 (5th Cir. 2000); *Peters v. Jim Lupient Oldsmobile Co.*, 220 F.3d 915, 917 (8th Cir. 2000). The most restrictive definition of "detrimental reliance" adopted by these courts is: the consumer must show that 1) he read the TILA disclosure, 2) he understood the charges being disclosed, 3) had the statement been accurate, he would have sought a lower price, and 4) he would have obtained a lower price. *Peters*, 220 F.3d at 917.

329 *Truth in Lending (Regulation Z)*, 12 C.F.R. §§ 226.15(d)(2), 226.23(d)(2) (2007); 12 C.F.R. pt. 226, supp. I, §§ 226.15(d)(2) cmts. 1 & 2; 226.23(d)(2) cmts. 1 & 2 (2007) (Official Staff Interpretations).

330 For fixed-term mortgage loans, only the failure to disclose accurately the APR, the finance charge, the amount financed, the total payments, or the payment schedule; the failure to comply with certain provisions of the Home Ownership and Equity Protection Act; or the failure to provide properly the notice of right to cancel trigger the extended right to rescind. 15 U.S.C. §§ 1602(u), 1635(a), (f), 1639(j) (2000); 12 C.F.R. § 226.23 (a)(3) n.48. There is a slightly different list for open-end real estate secured loans. 12 C.F.R. § 226.15(a)(3) n.36.

331 *McKenna v. First Horizon Home Loan Corp.*, 475 F.3d 418, 427 (1st Cir. 2007); *James v. Home Constr. Co.*, 621 F.2d 727, 730 (5th Cir. 1980).

332 15 U.S.C. § 1607(a) (2000). The Office of the Comptroller of the Currency oversees national banks, the Board oversees state member banks of the Federal Reserve System and branches of foreign banks, the Office of Thrift Supervision oversees saving associations, the Federal Deposit Insurance Corporation oversees state banks that are not members of the Federal Reserve System, and the National Credit Union Administration Board oversees federal credit unions.

333 15 U.S.C. § 1607(c) (2000).

334 *Id.* § 1607(e).

was extended.<sup>335</sup> The industry is rarely heard to complain about agency enforcement of TILA.

Finally, when compared to the enormous volume of credit extended, even the total restitution ordered, let alone the recovery of any one consumer or even a class of consumers is quite miniscule. For example, the total amount of consumer credit outstanding in 2006 surpassed \$2.3 trillion.<sup>336</sup> Between 2003 and 2006, inclusive, three federal agencies ordered \$3.8 million in restitution, or only slightly more than one-millionth of the consumer credit outstanding in 2006.<sup>337</sup> Similarly, even if we assume that in every case filed in the federal district courts labeled “Fraud, including Truth In Lending,” the plaintiff filed a TIL claim, sought rescission, prevailed, and obtained an award of \$50,000, the resulting liability would be less than six thousandths of one percent of the outstanding consumer credit.<sup>338</sup>

In successful suits, the defendants must pay both the consumers’ and their own attorneys’ fees, which can significantly add to the price tag. However, these litigation costs are more within the industry’s control than it might like to admit because lenders can avoid liability by packing all fees into the finance charge when in doubt. Adoption of the litmus test will create bright lines, reduce uncertainty, and, consequently, will decrease costs of compliance and litigation.

## B. *APR Inflation*

The disparity between a fee-inclusive APR and the contract interest rate would be greater than under the present rules if our litmus test were adopted. Any alarm voiced about this consequence is overstated.

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335 *Id.* § 1607(e)(2). The agency must also consider whether the restitution would have a significantly adverse impact upon the safety and soundness of the lender. *Id.* § 1607(e)(3).

336 See G.19 Fed. Reserve Stat. Release: Consumer Credit (Apr. 6, 2007), <http://www.federalreserve.gov/releases/g19/20070406/g19.pdf>.

337 2006 BD. OF GOVERNORS OF FED. RESERVE SYS. ANN. REP. 106; 2005 BD. OF GOVERNORS OF FED. RESERVE SYS. ANN. REP. 101-102; 2004 BD. OF GOVERNORS OF FED. RESERVE SYS. ANN. REP. 71; 2003 BD. OF GOVERNORS OF FED. RESERVE SYS. ANN. REP. 69-70, available at <http://www.federalreserve.gov/boarddocs/rptcongress/default.htm>. (reporting numbers for the Board and the FDIC for 2003-2006, and for the OTS for 2003 only).

338 The Administrative Office of the United States Courts reported that only 2,517 “Fraud, including Truth In Lending” cases were filed in the federal district courts in the year ending March 31, 2006. Administrative Office of the United States Courts, Table(C)-2 (March 31, 2005 to March 31, 2006), [http://www.uscourts.gov/caseload2006/tables/C02\\_Mar\\_06.pdf](http://www.uscourts.gov/caseload2006/tables/C02_Mar_06.pdf) (last visited May 5, 2008). \$50,000 x 2,517 = \$125.85 million. This estimate overstates considerably the potential liability for the industry. Rescission is the most expensive remedy and is available only to a small subset of all consumers and a recovery of \$50,000 on a rescission claim would be on the high side. Class action rescission claims present the possibility of significantly higher damages. If a class consisted of 10,000 members, the potential liability could be as high as \$500 million if each member validly rescinded and filed a claim. In that case, the cost is only two one thousandths of a percent of the total consumer credit outstanding in 2006. As noted above, at least two appellate courts have been unwilling to certify class actions seeking rescission.

First, the feared disparity would be “a hike only in comparison to the past *disclosed* levels, which were, of course, artificially understated.”<sup>339</sup> Second, the creditor itself has control over whether to unbundle its fees, outsource origination functions, and create complex pricing structures. Creditors are free to include the entire price of credit in the interest rate. Third, at least for closed-end mortgage loans, the disclosed APR will not be significantly higher than those disclosed under the existing looser rules. The Federal Reserve Board included this example in its 1998 Report:<sup>340</sup>

Figure 1. Effect of modification to the finance charge on the APR\*

Approaches for finance charge disclosure	APR (percent)
Current TILA	7.20
“Required-cost”	7.52

\* For a \$100,000 loan, with a thirty-year term, a fixed interest rate of 7 percent; \$2,000 in discount points; \$3,000 in required closing costs (title, appraisal); and \$1,000 in costs for optional services; all costs financed.

The litmus test we propose will cover more of the closing costs than the Board’s “required-cost” proposal. Adding \$1,000 of additional optional services into the finance charge increases the APR to only 7.62%. In shorter-term transactions, the effect will be greater. The chart below highlights the differences:

Figure 2: Effect of modification of the APR: car loans, small installment loans, credit cards

Type of Loan	Current APR (%)	Litmus Test APR (%)
Car loan	8.43*	9.52*
Small personal loan	12.76+	19.29+
Credit card monthly statement	18.73●	49.2●

\* For a \$20,000 loan, with a five-year term, a fixed interest rate of 8%; \$500 optional credit insurance; \$200 document fee imposed in only credit transactions.

+ For a \$3,000 loan, with a one-year term, a fixed rate of 12%; \$100 optional credit insurance; \$12 non-filing insurance fee.

339 Keest, *supra* note 3, at 364.

340 FRB/HUD REPORT, *supra* note 20, at 14.

- For a \$3,000 credit card balance; an annual interest rate of 18% or monthly rate of 1.5%; interest charge of \$45; one cash advance fee of \$3; annual fee of \$75.<sup>341</sup>

The inflation is most apparent in the short-term, small loan context and on the credit card periodic statement APR. Nevertheless, *all* creditors will experience the same inflation if they offer the same or similar products. The effect will resonate industry-wide. No one creditor will be singled out and, consequently, competition should not be retarded. Instead, brighter lines make compliance with the law easier and cheaper. Most importantly, the jump in APRs will bring home to consumers the true cost of credit in a powerful way, result in increased competition and more efficient markets,<sup>342</sup> and reduce excessive debt loads.<sup>343</sup>

Authors Rohner and Durkin suggest that a more inclusive finance charge definition could persuade lenders to stuff their unbundled costs back into the interest rate in order to avoid disclosing APRs significantly higher than the interest rate.<sup>344</sup> This result would be quite beneficial. When the interest rate and the APR are the same, confusion between these two numbers is eliminated. Transparency is greater because creditors cannot hide the true cost of the loan in fees that the APR does not take into account.

Before the passage of TILA, creditors voiced the concern that disclosure of the cost of credit would dry up credit.<sup>345</sup> However, their worst fears did not come to pass then and the financial sky would not fall now.

### C. *The Utility of the APR*

Some may complain that consumers do not understand the APR. As discussed above, consumers do not need to understand the APR to use it to shop. Consumers cannot effectively shop for credit without a single number that combines both interest and fees. Denying consumers the benefit of the APR sows the seeds of abusive pricing.

A frequent question is: what is the difference between the APR and the loan interest rate? Some consumer confusion may arise when these numbers

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341 The 18.73% APR was calculated based upon a balance of \$3,075, since the \$75 annual fee is not a finance charge under current rules. If we computed the current APR on a \$3,000 balance, the APR would be 19.2%. We used a balance of \$3,000 to calculate the litmus test APR because the annual fee is a finance charge under that standard.

342 See Stango & Zinman, *supra* note 28, at 3-4 (finding that markets where APR is disclosed have lower rates of interest and APRs, particularly for consumers with most pronounced difficulty evaluating the cost of credit).

343 See Bar-Gill, *supra* note 178, at 1403-04 (noting that information can counteract overoptimism bias in credit purchases and reduce excess consumption of credit).

344 Rohner & Durkin, *supra* note 88, at 171-72.

345 See, e.g., *House Hearings*, *supra* note 5, at 826 (testimony of Stanley R. Barber, President, Independent Bankers Association of America) (concurring that banks will no longer make small loans).

are not identical. The Board could address this issue by adding a simple explanation to the TIL disclosure, such as: "The APR includes the fees charged you in connection with this loan and is higher than the interest rate for this reason."<sup>346</sup>

As reflected in the Board's advance notice, some have criticized the TIL disclosure regime as generating "information overload."<sup>347</sup> Information overload, properly understood, refers to the volume of disclosure.<sup>348</sup> Neither TILA nor the APR is responsible for information overload. The bulk of the material given consumers—which indeed may be too much and which can be manipulated to overshadow the most important information—is required not by TILA but by lenders.<sup>349</sup> In a fixed-rate home mortgage purchase transaction, for example, only one piece of the reams of paper given the consumer at closing is required by TILA.<sup>350</sup>

The danger posed by too much information is selective ignorance; the risk is that a key piece of information may be ignored.<sup>351</sup> When faced with too much information, or overwhelmingly complex tasks, consumers seek a "good enough" solution.<sup>352</sup> Consumers seek an alternative that meets minimum requirements without expending too much energy in the search.<sup>353</sup> The APR,

346 Cf. MACRO INT'L, INC., *supra* note 27, at 47 (stating that relabeling the periodic statement APR the "Fee-Inclusive APR" increased both understanding of the periodic statement APR and appreciation of its utility).

347 See Edwards, *supra* note 8, at 221-23. Proponents of this theory argue that when faced with too much information, consumers shut down. See Sovern, *supra* note 208, at n.70 (compiling citations to the research and debate).

348 David M. Grether, Alan Schwartz & Louise L. Wilde, *The Irrelevance of Information Overload: An Analysis of Search and Disclosure*, 59 S. CAL. L. REV. 277 (1986) (discussing information overload theory, which posits that consumers cannot process large amounts of data).

349 GAO CREDIT CARD REPORT, *supra* note 13, at 51-52; Peterson, *supra* note 13, at 891 ("[M]any creditors inject complexity into their contracts . . . simply for the strategic value of the complexity itself.").

350 This is the final TIL disclosure of the cost of credit. In addition to this document, consumers should have received an early "estimate" of TIL disclosures within three days after application in home purchase loans. 15 U.S.C. § 1638(b)(2) (2000). For refinancing loans, consumers also receive two copies each of a notice of right to cancel. 12 C.F.R. §§ 226.15(b), 226.23(b) (2007). There are some additional documents required by other federal law, most notably the Real Estate Settlement and Procedures Act (RESPA), 12 U.S.C. §§ 2601-2617 (2000). RESPA mandates the provision of the HUD-1 or settlement statement, detailing the costs paid at closing. 12 U.S.C. § 2603(a) (2000). RESPA also requires a disclosure as to businesses affiliated with the lender. 12 U.S.C. § 2607(c)(4) (2000), 24 C.F.R. § 3500.15(b)(1) (2007), and information as to the likelihood of the loan's being sold. 12 U.S.C. § 2605(a) (2000), 24 C.F.R. § 3500.21(b) (2007). See also Elizabeth Renuart, *Toward One Competitive and Fair Mortgage Market: Suggested Reforms in A Tale of Three Markets Point in the Right Direction*, 82 TEX. L. REV. 421, 431-32 (2003) (identifying the few mortgage documents required by federal law).

351 Jacob Jacoby, *Perspectives on Information Overload*, 10 J. CONSUMER RES. 432, 435 (1984).

352 See Herbert A. Simon, *Rationality as Process and as Product of Thought*, 68 AM. ECON. REV. 1, 11-12 (1978) (describing general models of decision making in the face of complexity); Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 Q. J. ECON. 99, 118 (1955) (positing the "good enough" solution).

353 Yu-Chun Regina Chang & Sherman Hanna, *Consumer Credit Search Behavior*, 16 J. CONSUMER STUD. AND HOME ECON. 207 (1992).



rather than being a cause of information overload, is an answer to information overload.

### XIII. Conclusion

The drafters of TILA were aware that disclosures grounded in even basic computational skills were inadequate for most of the population.<sup>354</sup> The creation of the APR was an attempt to provide one simple, comparable number that did not require any intermediate computational steps. The credit industry has transformed the market in the intervening forty years through unbundling, outsourcing of credit functions, and complex pricing structures. These changes should not be allowed to undermine a standardized, inclusive measure of the cost of credit.

Does “fixing” the APR need congressional attention or can much of the slippage in the effectiveness of the APR be accomplished by Board action? To the extent that the Act contains explicit exceptions to the general finance charge definition, which it does, Congress bears the responsibility of fixing those loopholes. In light of our suggested litmus test, Congress should repeal provisions in section 1605 that exclude credit insurance premiums and certain real estate related fees when imposed only in credit transactions.

Short of congressional action, however, the Board can and should pump up the utility of the APR to effectuate the goals of TILA. The responsibility for much of the leakage rests with the Board. The Act also gives the Board the authority to address the timing of the disclosures so consumers can be well informed earlier in the evaluation process.

The moment is right, given the regulatory review process commenced by the Board in 2004—a process that is still in its early stages. The Board has already recognized that the APR is weakened by the unbundling of fees. If the Board is serious about financial literacy and informed consumer choice, it should embrace a “fully loaded” APR.

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354 See *supra* notes 32, 33.

